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No. _____

In The

Supreme Court of the United States

October Term, 1992

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.

Petitioner,

vs.

JOHN B. CAMP, TRUSTEE,
SECURITIES INVESTOR PROTECTION CORPORATION,

Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. WHETHER CASE AND STATUTORY LAW PERMITS A TRUSTEE, IN A STOCKBROKER LIQUIDATION PROCEEDING COMMENCED BY THE SECURITIES INVESTOR PROTECTION CORPORATION ("SIPC") PURSUANT TO THE SECURITIES INVESTOR PROTECTION ACT, 15 U.S.C. § 78aaa, et. seq. ("SIPA"), TO SELECTIVELY INVALIDATE PROVISIONS OF A FIDELITY BOND WHICH SIPC HAS APPROVED AND WHICH SIPA REQUIRES ALL SIPC MEMBERS TO CARRY.

2. WHETHER SIPA § 78fff(b) PERMITS THE "ANTI-IPSO-FACTO" PROVISION OF THE BANKRUPTCY CODE, 11 U.S.C. § 541(c)(1)(B), TO BE USED IN A SIPA STOCKBROKER LIQUIDATION PROCEEDING.

LIST OF INTERESTED PARTIES

Securities Investor Protection Corporation; Theodore H. Focht; Michael E. Don; Josephine Wang

John H. Camp, Jr., Trustee, Blackwell, Walker & Hoehl; Neal B. Shniderman

Carl K. Hoffmann; James F. Crowder, Jr.; Guy W. Harrison; Kimbrell & Hamann, P.A.

The Honorable A. Jay Cristol, U.S. Bankruptcy Judge (The Hon. Eugene Spellman, U.S. District Judge below, is deceased)

National Union Fire Insurance Company of Pittsburgh, PA. National Union is a wholly-owned subsidiary of American International Group. National Union does not have any non-wholly owned subsidiaries.

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REFERENCE TO LOWER COURT OPINIONS

1. In re Government Securities Corp., 972 F.2d 328 (11th Cir. 1992)
2. In re Government Securities Corp., 111 B.R. 1007 (S.D.Fla. 1990)
3. In re Government Securities Corp., 101 B.R. 343 (S.D.Fla. 1989)

STATEMENT OF JURISDICTION

This is a petition for review by Writ of Certiorari of a judgement of the United States Court of Appeals for the Eleventh Circuit entered on September 14, 1992. Jurisdiction is conferred upon this Court by 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED IN THE CASE

1. 11 U.S.C. § 541
2. 15 U.S.C. § 78fff
3. 15 U.S.C. § 78iii

Pursuant to Rule 14(f) of the Supreme Court Rules, these statutory provisions are included in the appendix.

STATEMENT OF THE CASE

National Union Fire Insurance Company of Pittsburgh, PA ("National Union") issued a standard form Securities Dealer Blanket Bond No. 959-9000 ("bond") to Government Securities Corp. ("GSC") on February 1, 1987, for the period February 1, 1987 to November 1, 1987. Section 12(c) of the bond provided for immediate termination of the bond upon takeover of the bonded securities institution, as follows:

> The bond shall be deemed terminated or cancelled as an entirety . . . immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials. . . .

Bond ¶12(c) (Exhibit "A" to Trustee's Amended Complaint served September 30, 1988).

On May 12, 1987, the Securities Investor Protection Corporation ("SIPC") filed an application in the District

Court for the Southern District of Florida seeking a protective decree adjudicating that the customers of GSC, a securities broker, were in need of protection under the Securities Investors Protection Act of 1970, as amended ("SIPA"), 15 U.S.C. §§ 78aaa, *et seq.* Federal court jurisdiction was founded upon 15 U.S.C. § 78eee(a)(3) and (b)(2). GSC consented to the entry of an order appointing a trustee for the liquidation of its business pursuant to SIPA. (R1-8, item 9).

That same day, United States District Judge Alcee L. Hastings entered an order commencing a liquidation proceeding for GSC under SIPA. (R1-8, item 10). At the request of SIPC, Judge Hastings appointed John R. Camp, Jr. as Trustee. The May 12th order removed the Title 15 liquidation proceeding to the bankruptcy court for the Southern District of Florida pursuant to 15 U.S.C. § 78eee(b)(4).

On June 2, 1987, the SIPA Trustee wrote a letter to National Union to inform it of a possible loss under the bond. (Tr.Exh. 1). The Trustee filed a proof of loss on December 7, 1987. (Bankruptcy Trial Transcript, at 55). On December 23, 1987. National Union denied coverage on the ground that the bond automatically terminated upon the May 12, 1987 filing of the Application for a Protective Decree and appointment of a SIPC trustee to liquidate GSC. R2-18-3.

On August 11, 1988, the Trustee filed an adversary action in the bankruptcy court against National Union seeking money damages for breach of the bond. (Trustee's Complaint). Thereafter, the Trustee amended its complaint to seek a judgement declaring the rights of the parties under the bond. (Trustee's Amended Complaint, served September 30, 1988).

On November 15, 1988, in an omnibus order, the bankruptcy court denied *inter alia* National Union's motion to dismiss and held that "relevant portions of the Bankruptcy Code which prevent an automatic termination or limitation of

the estate's property rights upon the filing of a bankruptcy proceeding or the appointment of a bankruptcy trustee are applicable in this adversary matter filed in a SIPA proceeding." On March 15, 1989, the bankruptcy court entered its Findings of Fact and Conclusions of Law and its Final Judgment. In its conclusions of law, the bankruptcy court readopted its November 15, 1988 holding with respect to the bond's termination clause. National Union timely filed its Notice of Appeal to the district court on March 27, 1989.

On March 16, 1990, the District Court entered an Order Affirming Bankruptcy Court in which he affirmed the bankruptcy court's holding that the termination-upon-takeover provision of the bond was invalid and void in Title 15 [SIPA] liquidation proceedings.

On September 14, 1992, the Eleventh Circuit issued its judgement affirming the bankruptcy court's and the District Court's decisions.

REASONS FOR GRANTING THE WRIT

POINT I

THE ELEVENTH CIRCUIT'S HOLDING THAT A GOVERNMENT INSURER-LIQUIDATOR MAY SELECTIVELY INVALIDATE PROVISIONS OF A STANDARD BOND WHICH THE GOVERNMENT INSURER HAS APPROVED AND WHICH APPLICABLE STATUTES REQUIRE INSURED ENTITIES TO CARRY DIRECTLY CONFLICTS WITH DECISIONS OF THE FIFTH, SIXTH AND NINTH CIRCUIT COURTS OF APPEAL ON THE SAME POINT OF LAW.

This case presents a straightforward question of law: may the government, having required a regulated company to carry a government-approved fidelity bond, selectively invalidate provisions of that bond which work to the government's disadvantage during liquidation proceedings? Three Circuit Courts of Appeal have answered this question with a resounding "no." *California Union Insurance Co. v. American Diversified Savings Bank,* 948 F.2d 556 (9th Cir. 1991); *FDIC v.*

Aetna Casualty and Surety Co., 903 F.2d 1073 (6th Cir. 1990); *Sharp v. FSLIC*, 858 F.2d 1042 (5th Cir. 1988).

Only the Eleventh Circuit, in the present case, has stated that such inconsistent conduct is acceptable. By so holding, the court rejected fundamental principles of law and fairness. The Eleventh Circuit's cursory analysis also did not address the factual similarities between the FDIC/FSLIC statutes and SIPA which compel the same result in the *Sharp* cases and in the present case. Both statutory schemes are identical in that they require industry members to carry fidelity bond insurance in the standard form negotiated between the industry members, the Surety Association of America, and the regulators themselves.

Sharp, *Aetna* and *California Union* all recognize that the government cannot repudiate during liquidation proceedings the very fidelity bonds which it has required pursuant to regulation. There is no factual or legal distinction between the present case and *Sharp*, *Aetna* and *California Union* which justifies the Eleventh Circuit's contrary and conflicting holding.

A. SIPA ESTABLISHES A SYSTEM OF INSURANCE FOR CUSTOMERS AND REGULATION OF ITS MEMBER FIRMS.

The primary purpose of SIPA is to provide insurance against customer loss. The financial stability and integrity of SIPC members is crucial to minimize insured losses, and SIPA does indeed provide for extensive regulation of the affairs of SIPC members. In fact, SIPA's requirement of member compliance with "applicable financial responsibility rules" is perhaps its most important aspect.

From the genesis of its legislative history through recent court decisions, SIPC has been referred to as an insurer and compared to other federal corporations charged with insuring particular segments of the financial economy. The legislative history of SIPA shows that SIPA was "enacted to provide to customers of security broker-dealers protection against losses which might occur as a result of the financial failure of

broker-dealers."[1] The "most striking feature of the SIPA is the insurance program, administered by the SIPC." **Note,** "The Securities Investor Protection Act of 1970: An Early Assessment," 73 Columbia Law Review 802, 803-804 (1973). This Court and lower federal courts have consistently recognized that the main purpose of SIPA is to protect members of the investing public against individual hardship, and to restore investor confidence. *Securities Investor Protection Corporation v. Barbour,* 421 U.S. 412 (1975); *In Re Stalvey & Associates, Inc. (Securities Investor Protection Corporation v. Wise),* 750 F.2d 464 (5th Cir. 1985); *In Re Securities and Exchange Commission v. White & Co., Inc.,* 546 F.2d 789 (8th Cir. 1976); *Securities and Exchange Commission v. Packer, Wilbur & Co., Inc.,* 498 F.2d 978 (2d Cir. 1974).

SIPC functions as an insurance company funded by contributions of its members for the purpose of protecting the investors. All persons registered as brokers or dealers under Section 15(b) of the 1935 Act [15 U.S.C. § 78o(b)] are required to be members of SIPC. 15 U.S.C. § 78ccc(a)(2). In the event that the SIPC insurance fund is deemed inadequate for the purposes of the Act, the Department of the Treasury is authorized to make loans to SIPC not to exceed $1 billion. 15 U.S.C. § 78ddd(h). As the Ninth Circuit Court of Appeals held in 1986, SIPC protects "the customers of securities brokers by *insuring* the net equity of customers' accounts up to specified maxima." *Securities Investor Protection Corporation v. Vigman,* 803 F.2d 1513, 1516 (9th Cir. 1986), citing *Touche Ross & Co. v. Redington,* 442 U.S. 560, 564-565 n.5 (1979) (emphasis supplied). Although the Ninth Circuit recognized that SIPC insurance had various limits on the amount of coverage, it is nevertheless an insurer. *Vigman,* 803 F.2d at 1516.[2]

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[1] *See* S. Report. No. 95-763, 95th Cong., 2d Sess. (1978), reported in 1978 U.S. Code Cong. and Adm. News 764.

[2] Protection is the general object and purpose of insurance by affording indemnity or security. *See* Couch on Insurance 2d. (Rev. Ed.) Section 1:2. Limiting coverage or the class of individuals who are protected in no way alters the fact that insurance is provided.

SIPA's purpose, however, is broader than simply having the government, through SIPC, pick up the pieces after a stockbroker fails. An essential part of SIPA's "insurance" function is to assure that SIPC members continue as viable, ongoing concerns. It is inconceivable that Congress would create a stockbroker customer insurance program, backed by a $1 billion federal line of credit, without taking some steps to require the insured institutions to comply with strict standards of operation.

SIPA takes this self-evident principle into account. The legislative history of SIPA confirms that a regulatory mechanism was one of the primary purposes of the Act:

> [SIPA] is intended to serve several purposes: to protect individual investors from financial hardship; to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general *upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss.*

S. Rep. No. 1218, 91st Cong., 2d Sess. 4 (1970) (emphasis added). *See also* H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. 1 (1970) (same language as that emphasized above).

SIPC itself was never intended to have direct regulatory powers. Given the extensive authority of the SEC and the longstanding regulatory practices of self-regulatory organizations ("SRO's") such as the stock exchanges and the National Association of Securities Dealers ("NASD"), Congress wanted to avoid adding yet another layer of expansive direct regulation in the securities industry. SIPC First Annual Report, 1971 p. 6. Nevertheless, Congress recognized that regulation and improvement of industry financial practices was essential in order to prevent insured losses from occurring. Thus, Congress, through 15 U.S.C. § 78iii, imposed the extant network of SEC/SRO rules and regulations on all SIPC members, with SIPC given an advisory role in refining and

developing the SROs' standards. SIPA § 78iii(c) provides that "[t]he self-regulatory organization of which a member of SIPC is a member or in which it is a participant *shall* inspect or examine such member for compliance with *applicable financial responsibility rules*. . . . " (emphasis added). Thus, the rules of the self-regulatory organizations are imposed, by SIPA, directly on all SIPC members just as surely as if those rules had been promulgated by SIPC itself.

SIPC itself has recognized the mandatory nature of SRO rules when it stated that "financial responsibility rules" include both the rules promulgated by the SEC and "rules prescribed by a national securities exchange." SIPC specifically acknowledged that the existing rules of the Exchanges and the National Association of Securities Dealers, Inc. ("NASD") were to be applied to SIPC members. SIPC 1971 Annual Report, pp. 30-31.

SIPC also has recognized SIPA's success in regulating the financial practices of SIPC members through the rules of the SROs:

> **SELF-REGULATORS EXAMINE SIPC MEMBERS**
>
> SIPA's Section 13 [78iii] was designed to upgrade the financial practices and responsibility of securities industry members over a period of time. [citing to 78iii(e)].
>
> * * *
>
> Improved broker-dealer operations and the combination of more stringent requirements for entering the securities business, *new financial responsibility rules*, and noticeable improvement in monitoring broker-dealer financial condition by the SEC and SROs since SIPC's inception *contributed to a sharp decline in the number of customer protection proceedings commenced in the late 1970s.*

Brochure entitled "SIPC and Customer Protection" published by SIPC (3rd Ed. April 1992) (emphasis added).

Even so, SIPC was not left without a role in the regulation process. Section 78iii(e) gave SIPC a statutory mandate ("shall") to review existing rules and regulations, and consult

with the SROs regarding strengthening of financial responsibility requirements. One of SIPC's first actions was to ask the Exchanges and the NASD for data regarding their rules so that SIPC could commence its review. SIPC First Annual Report, 1971, at p. 30 n. 49. Thus, SIPC participation in the regulatory process carries much weight in the development of additional regulations. The best example of SIPC's influence over the regulatory process is the instigation of the mandatory fidelity bonding requirement which is at the heart of this case and discussed in section "C", *infra*.

B. THE INSURANCE/REGULATORY ASPECTS OF SIPA AND SIPC ARE SIMILAR IN ALL MATERIAL RESPECTS TO THOSE OF THE FDIC/FSLIC.

The similarities between FDIC and SIPC are obvious. Just as SIPA's purpose is to protect individual customers from stockbroker failures and restore public confidence in the securities trading industry, "the policies [of the FDIC/FSLIC statutory schemes] are promoting the stability of, and confidence in, the nation's banking system." *Gunter v. M. Hutcheson*, 674 F.2d 862, 870 (11th Cir. 1982).

The regulatory scheme for insurance under SIPA is similar to the regulatory scheme for insurance of FDIC/FSLIC members. Each corporation has its membership of insured institutions defined by statute. *See* 15 U.S.C. § 78ccc(a)(2), (SIPC, e.g., persons registered as brokers and dealers under 1934 Securities Exchange Act); 12 U.S.C. §§ 1813(b), (d) and (h), §§ 1814 and 1815, (FDIC, e.g., includes banks that are members of Federal Reserve Board); and 12 U.S.C. §§ 1724 and 1726 (FSLIC). Each of these statutory corporations has its powers prescribed by statute, as well as the details for appointment of a board of directors. *See* 15 U.S.C. § 78ccc(b) and (c) (SIPC), 12 U.S.C. §§ 1812 and 1819 (FDIC), and 12 U.S.C. § 1725(a) and (c) (FSLIC). And SIPC, FDIC, and FSLIC all impose assessments on the respective member institutions. *See* 15 U.S.C. § 78ddd(c) (SIPC), 12 U.S.C. 1817(b) (FDIC), and 12 U.S.C. § 1727(b) (FSLIC); *and see*

Sowards and Mofsky, "The Securities Investor Protection Act of 1970", 16 Bus.Law 1271, 1277 (1971).[3]

Thus, as with FDIC and FSLIC, the securities dealer or broker that is forced into a liquidation by SIPC has the backing of a federal government-authorized insurance fund for the payment of customer claims, with limits on the amount of claims for each customer.[4] It is not surprising then, that courts often compare the functions of FDIC to SIPC. *See Securities and Exchange Commission v. Albert & Maguire Securities Co., Inc.*, 560 F.2d 569, 571 (3d Cir. 1977); *Securities and Exchange Commission v. Aberdeen Securities Co., Inc.*, 526 F.2d 603, 605 (3d Cir. 1975); *In re: Matter of Lewellyn*, 26 Bankr. 246, 253 (Bankr. D. Vir. 1982).

Even SIPC has made the comparison.[5] SIPC's 1986 information brochure discusses SIPC's legislative history:

> Representatives of the securities industry, the Federal Reserve Board, Office of Management and Budget, the Department of the Treasury, and the SEC conferred on draft bills proposed by the industry group and the SEC staff. *Their joint proposal would have created an organization performing a role in the securities industry somewhat similar to those established to insure depositors to banks, savings and loan associations and credit unions; that is, the Federal Deposit Insurance Corporation*

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[3] The FSLIC provisions were repealed by the Financial Institutions Reform, Recovery, and Enforcement Act (F.I.R.R.E.A.) of 1989, Pub. Law 101-73, Title IV, § 407, 103 Stat.363. All provisions set forth above with reference to FDIC are now also applicable to RTC.

[4] *See* 15 U.S.C. § 78fff-3(a) (SIPC limitation of $500,000 for cash and securities per customer, with maximum of $100,000 in cash) 12 U.S.C. 1821(a) (FDIC maximum of $100,000); 12 U.S.C. §§ 1724(b) and 1728 (FSLIC, same).

[5] SIPC's 1983 Annual Report compares FDIC, FSLIC and SIPC and states, on p. 14 under the heading "SIPC Image and Awareness Study", – "A majority of brokers (77%) report that their average customer understands that his accounts are insured."

(FDIC), Federal Savings and Loan Insurance Corporation (FSLIC) and National Credit Union administration (NCUA).

"SIPC and Customer Protection", (2d ed. April 1986), page 1.

Like FDIC/FSLIC, SIPC has extensive power to control the affairs and conduct examinations of its member corporations. The only difference is the mechanism: FDIC/FSLIC regulates and examines directly using their own rules and personnel while SIPC uses the self-regulating organizations in the securities industry (which have no parallel in the banking industry) as its agents for promulgating financial responsibility rules, examining members for compliance and reporting on member compliance to SIPC. This difference in mechanics, however, has no difference in substance. The bottom line is that both statutory schemes impose specific and extensive regulatory requirements on their respective industries.

C. SIPA REQUIRED GSC TO HAVE THE STANDARD INDUSTRY FORM FIDELITY BOND, WHICH CONTAINS THE PROVISION SIPC IS ATTEMPTING TO SELECTIVELY INVALIDATE DURING A TITLE 15 STOCKBROKER LIQUIDATION PROCEEDING.

SIPA itself required GSC to have the industry standard form fidelity bond. SIPC was instrumental in developing this requirement, and was fully aware of the content of the standard bond negotiated between the securities industry and the Surety Association of America, including the very provision of which SIPC now complains. One of SIPC's first priorities was the development of industry rules requiring bonding of SIPC members:

> SIPC recently received advice that some progress was being made by the NASD and the Commission with representatives of certain insurance companies on the subject of requiring bonding of brokers, or dealers doing a public securities business – *a matter raised by SIPC in 1971.*

SIPC First Annual Report, 1971, at p. 32 (emphasis added). The following year, SIPC reported that its efforts had been fruitful:

> Finally, as indicated in our first annual report, the Corporation has expressed concern that many brokers do not carry basic fidelity bonds. We have urged the Commission and the NASD to require brokers to obtain blanket fidelity bonding, and we are pleased to note that the membership of the NASD recently approved a proposal which authorized its board of Governors to require that NASD members, who are members of SIPC . . . obtain such bonds. . . . It is anticipated that the NASD will finalize action on this rule in the near future.

SIPC Second Annual Report, 1972, at p. 37. Thus, SIPC requested the SROs to develop bonding requirements, and had full knowledge that the SROs and the Surety Association of America worked together to develop the required bond.

The NASD rule developed in response to SIPC's request provides as follows:[6]

> Par. 2182 Fidelity Bonds
> Sec.32
> Application
>
> (a) Every member shall be required to carry a blanket fidelity bond meeting requirements as to form, amount and type of coverage as the Board of Governors may prescribe pursuant to the authorization granted by paragraph (b) hereof.
>
> * * *
>
> Par. 2182A APPENDIX C
> Coverage Required
>
> (a) Each member required to join the *Securities Investor Protection Corporation . . . shall:*
>
> (1) Maintain a blanket fidelity bond, in a form substantially similar to the standard form of Brokers Blanket Bond promulgated by the Surety Association of America. . . .

(emphasis added). In the present case, the NASD was the self-regulatory organization with authority over GSC. The bond

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[6] The full text of the NASD Rule is set forth in the Appendix.

obtained by GSC was in fact the "standard form of Brokers Blanket Bond." Thus, through the "chain of command" set forth in § 78iii, SIPA required, and SIPC approved, GSC's bond.

SIPC attempted to gloss over this fact in their brief to the court below by stating that "maintenance of the bond is not a prerequisite to *SIPC* membership" and that *"SIPC itself* has no regulatory authority over its members, and no authority to require its members to purchase a bond." (SIPC Brief at 26) (emphasis added). While these statements are technically correct, they are deceptively phrased to divert attention from the fact that SIPA makes the self-regulatory organizations the "examining authorities" on behalf of SIPC, and gives those authorities power to enforce their own "financial responsibility rules" on behalf of SIPC.

Even more significant, SIPC concealed from the court its active role in seeking rules requiring brokers to carry bonds, and its knowledge of the development and substance of those rules. SIPC cited the applicable NASD rules, but failed to disclose that NASD promulgated those rules at SIPC's prompting and in full consultation with SIPC pursuant to § 78iii(e). In addition, SIPC did not quote the full language of the NASD rule, thus concealing that the rule specifically requires the "standard form of Brokers Blanket Bond" which contains the automatic termination provision SIPC now seeks to avoid.

D. BECAUSE THE STATUTORY SCHEMES GOVERNING SIPA AND THE FDIC/FSLIC ARE IDENTICAL IN THAT THEY APPROVE OF AND REQUIRE THEIR PARTICIPATING MEMBERS TO CARRY THE STANDARD BOND, CASES UPHOLDING THE "AUTOMATIC TERMINATION UPON TAKEOVER" PROVISION OF THE STANDARD BOND AS AGAINST FDIC/FSLIC MANDATE THE SAME RESULT AGAINST SIPC.

Cases involving the FDIC/FSLIC uniformly have upheld the termination provisions of bonds, similar to paragraph

12(c) of National Union's bond, upon takeover by state or federal officials. *California Union Insurance Co. v. American Diversified Savings Bank,* 948 F.2d 556 (9th Cir. 1991); *FDIC v. Aetna Casualty and Surety Co.,* 903 F.2d 1073 (6th Cir. 1990); *Sharp v. FSLIC,* 858 F.2d 1042 (5th Cir. 1988); *FSLIC v. Transamerica Insurance Co.,* 705 F.Supp. 1328 (N.D.Ill. 1989). The rationale of all of these cases is identical: where the government requires regulated entities to have a standard bond, the government cannot later selectively invalidate provisions of the bond which may work to its disadvantage.

In *Sharp v. FSLIC,* 858 F.2d 1042 (5th Cir. 1988), the FSLIC relied on common law theories of contract interpretation to invalidate the automatic termination provision. In rejecting these arguments the court observed that the FSLIC's position would fundamentally alter the contract:

> First, terminations by receivership or takeover can be distinguished from terminations by the insurer or insured, in that a fidelity bond insures the fidelity of the employees and officers of the bank. In the case of a receivership or a takeover, the officials who purchased the bond to insure their own honesty are no longer in control of the institution. Takeover or receivership would substantially alter the character of the risk covered by the policy.

858 F.2d at 1045-46. By this language, the Court recognized that takeovers pose special risks for insurers not contemplated by the bond, justifying immediate relief from coverage.

The Court also noted that the bankers' blanket bond was jointly drafted by the sureties and FSLIC members. The Court refused to invalidate the termination clause on the grounds that "[i]ndeed, FSLIC, which in this case has stepped into the shoes of the insured, is the very institution which required that Underwriters issue their coverage under Form 22 in the first place." 858 F.2d at 1046.

In its conclusion, the Court noted the equitable problems raised by FSLIC's attempt to selectively invalidate provisions of the bond:

> We are aware that the conclusion we have reached may seem harsh to FSLIC, an institution

> beleaguered by thousands of thrift failures nationwide. The harshness of the rule is softened by two considerations. First, it is FSLIC itself that has chosen to require coverage under Form 22 as a condition of FSLIC membership. If it wishes an additional time period for discovering losses subsequent to establishment of a conservatorship, FSLIC need only alter its regulations.
>
> * * *
>
> In the face of the clear language of Form 22, we hesitate to rewrite judicially a standard form bond that has had a longer existence than FSLIC. If FSLIC finds the coverage provided by Form 22 inadequate, it need only require member banks to purchase an additional discovery period in the event of a type (c) termination.

Id. at 1048. By this latter language, the court recognized that requiring, through regulation, additional coverage after a federal takeover would at least give the sureties notice of their expanded obligations, and enable them to reassess their risks and their premiums accordingly. To force the sureties to provide such additional coverage with no compensation, by governmental elimination of their bargained-for limitations on such coverage, would be inequitable and unwarranted.

The bottom line of *Sharp* is basic fairness: the government cannot give with one hand and take away with the other. The principles set forth in *Sharp* consistently reappear in every case where the FDIC/FSLIC has attempted to selectively invalidate the automatic termination clauses. Perhaps most important, courts have applied these principles to defeat the FDIC/FSLIC's efforts to invalidate the automatic termination provisions even where the FDIC/FSLIC relies upon its broad statutory authority to act as a receiver and liquidator of troubled banks.

In *FSLIC v. Transamerica Insurance Co.*, 705 F.Supp. 1328 (N.D.Ill. 1989), the FSLIC argued that its powers as a receiver to collect all obligations owing to the insured institution were only limited by regulation of the Federal Home Loan Bank Board, citing 12 U.S.C. § 1279. Since the automatic termination provisions placed limits on FSLIC's ability

to collect obligations owing under a fidelity bond, they violated FSLIC's broad statutory authority and could be invalidated. *Id.* at 1336. The court disagreed:

> For the same reasons [stated in *Sharp*], FSLIC's arguments regarding the unenforceability of [the automatic termination provision] must fail. Having required Glenn Ellyn [Savings and Loan] to procure a Form 22 bond, FSLIC simply cannot now be heard to complain about the enforceability of its provisions.

Id. at 1337. Subsequent appellate authority has consistently agreed with the approach in *Transamerica.*

In *FDIC v. Aetna Casualty and Surety Co.*, 903 F.2d 1073 (6th Cir. 1990), the FDIC, instead of relying on a specific statutory provision, successfully asserted in the district court that the termination clauses were "contrary to public policy because they 'preclude the FDIC from discharging its responsibility in connection with marshalling the assets of the failed bank.' " *Id.* at 1077. The Sixth Circuit rejected this position, and upheld the termination provisions.

The court noted that 12 U.S.C. § 1828(e) stated that the FDIC "may" require insured institutions to carry a fidelity bond. Thus, even though no evidence had been presented to indicate that the FDIC had in fact exercised that authority, *Id.* at 1078, the Court concluded that:

> It is clear from § 1828 that Congress is aware of fidelity insurance and could, if it so desired, require its procurement and could set terms which would avoid the problem created by [the automatic termination clauses].
>
> * * *
>
> The FDIC also has statutory authority to require bond coverage and could require that such bond continue upon the appointment of FDIC as a receiver. To rule otherwise would be to force Aetna to take on a risk for which it did not bargain.

Id. The court found that the reasoning in *Sharp* was applicable even (1) where the bond was not mandated by the statutory scheme and (2) where the FDIC was relying on its statutory

powers as receiver and not on the common law of contracts as the source of its authority to invalidate the termination clause. "[T]he FDIC's contention that existing laws justify the invalidation of [the automatic termination clauses] must fail. The dominant public policy exposed by this review is that the parties' freedom of contract must not be disturbed." *Id.*

In *California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556 (9th Cir. 1991), FSLIC also argued that the automatic termination clause "violate[d] public policy because it 'infringe[d] on the power of the FSLIC to act as a receiver for failed institution.' " *Id.* at 562. The Court rejected this position, holding that:

> In this case, FSLIC required, pursuant to federal regulation, that the participating institutions maintain bond coverage in the form of Standard Form 22, or its equivalent. *See* 12 C.F.R. § 563.19(a) (1988). . . . FSLIC must be deemed to be aware of the provisions in the bond, and therefore in a position to alter the provisions and/or its regulations in order to provide additional time periods for it to discover losses. Consequently, we conclude that the Form 22 bond, with all of its provisions, is endorsed by the federal government by way of the federal agency responsible for the regulation of the savings and loan industry . . . through its requirement that the Standard Form 22 bond be used.

Id. The Court concluded that public policy supported the bond's automatic termination provisions.

The principles established in the *Sharp* line of cases are crucial to the present case because they preclude the government from invalidating bond provisions which it accepts under a statutory scheme, *regardless* of the breadth of its statutory authority as receiver and liquidator under other provisions of that scheme.

The *Sharp* cases should have compelled the same result in the present case. *Sharp* recognized that the fidelity insurance risk created by the installation of new management is substantially different from that originally bargained for by the surety. *Sharp*, 858 F.2d at 1045-46; *Aetna* 903 F.2d at 1078. This increased risk justifies automatic termination

because the FDIC/FSLIC appoints receivers or conservators to manage the bank who are different persons from the management which the surety agreed to insure. Like FDIC/FSLIC situations, SIPA liquidation proceedings require takeover of the institution and appointment of trustees by SIPC. *See* 15 U.S.C. § 78eee(b)(3). Thus, the enhanced insurance risk is identical to that which justifies automatic termination in the FDIC/FSLIC context.

The *Sharp* cases also recognized that these clauses are part of the standard fidelity policy developed through industry-wide negotiation between surety companies and the bonded companies. As the NASD standards and SIPC statements set forth above show, the sureties, SROs and securities dealers follow the exact same procedure for negotiating the standard Stockbrokers Blanket Bond. These facts are well known to Congress and to SIPC, and SIPC was the very entity which required member entities to have fidelity bonds. *See also Sharp* at 1046; *Aetna* at 1078; *California Union* at 562. Thus, SIPC had the power to require expanded coverage upon takeover, but did not do so, *Id. See also* 15 U.S.C. 78iii(e) (requiring SIPC to consult with the SROs concerning development of financial responsibility rules).

Finally, and most important, the *Sharp* cases establish that no matter how broad SIPC's liquidation authority might be, it is not broad enough to permit SIPC to invalidate contacts which SIPA has required and SIPC has accepted. SIPC specifically requested the development of bonding requirements, which directly led to the NASD rules applicable in this case. SIPC was fully aware of the SRO/insurance industry negotiations leading to the standard bond form. SIPA then imposed the bond form used in the present case on all SIPC members. Having accepted this standard bond as drafted, SIPC has no right to selectively invalidate provisions which do not suit its purpose during liquidation proceedings. The *Sharp* cases all mandate this obligation of consistency and basic fairness.

E. THE ELEVENTH CIRCUIT'S DECISION DIRECTLY CONFLICTS WITH THE DECISIONS OF THE FIFTH, SIXTH AND NINTH CIRCUIT COURTS OF APPEAL AND SHOULD BE REVERSED BY THIS COURT.

The Eleventh Circuit, in its opinion, offerred only the following explanation of why it refused to apply the rationale of the *Sharp* cases:

> That analogy is inapposite; the cited cases do not involve the bankruptcy code, and those institutions [FDIC/FSLIC] are not debtors in title 11 bankruptcy proceedings.

In re: Government Securities Corp., 972 F.2d at 331, n. 6. Not only did the Court ignore all of the facts which make this case identical to the *Sharp* cases, the one reason which it gave for distinguishing those cases is not a valid legal basis for making such a distinction.

It is true that FDIC/FSLIC liquidation proceedings do not rely on the provisions of the bankruptcy code. Application of Bankruptcy Code provisions, however, would not have made any difference in the *Sharp* cases, and there is no legally valid reason why it should make a difference here. In *Aetna, California Union* and *Transamerica,* the FDIC/FSLIC claimed that their own broad statutory authority to act as receiver and collect obligations owing to the failed bank permitted them to invalidate the automatic termination provisions of the bond. Although Bankruptcy Code provisions were not involved, the FDIC/FSLIC relied on statutory liquidation authority which was at least as broad as 11 U.S.C. § 541(c)(1)(B). *See, Aetna, supra,* 903 F.2d at 1077 (statutory power to marshall assets); *California Union, supra,* 948 F.2d at 562 (FDIC statutory power to act as receiver); *Transamerica, supra,* 709 F.Supp. at 1337 (FSLIC cited 12 U.S.C. § 1279, giving it plenary authority to collect obligations owing to the bank).

In each case, however, the courts ruled that these broad statutory powers during liquidation were not the controlling issue. The relevant inquiry was not the *scope* of government power under a single liquidation provision, but the *consistent exercise* of government power under the overall statutory

scheme. *See, Sharp, supra,* 858 F.2d at 1048; *Aetna, supra,* 903 F.2d at 1078; *California Union, supra,* 948 F.2d at 562; *Transamerica, supra,* 705 F.Supp. at 1337.

Thus, the reason advanced by the Eleventh Circuit for distinguishing this case from the *Sharp* cases is legally invalid.[7] Since the court offerred no legally supportable justification for its different conclusion, its decision must be seen as in direct conflict with the *Sharp* decisions. For all of the reasons set forth above, the *Sharp* cases reach reasonable, just and inevitable conclusions given their facts. Since the facts in the present case are identical in all material respects, this Court should reverse the decision of the Eleventh Circuit, and rule that SIPC is bound to accept the terms of the bond.

F. PERMITTING SIPC TO SELECTIVELY INVALIDATE THE BOND BY USING 11 U.S.C. § 541(c)(1)(B) ALSO WOULD BE INCONSISTENT WITH THE REQUIREMENTS OF 15 U.S.C. § 78iii, AND WOULD VIOLATE 15 U.S.C. § 78fff.

In addition to the case law set forth above, SIPA itself prohibits SIPC from acting inconsistently with the provisions of SIPA during a stockbroker liquidation proceeding. The fundamental flaw in SIPC's entire position is its belief that the broad bankruptcy powers granted to SIPC permit SIPC to do anything, even if it is inconsistent with actions required or approved of in other sections of SIPA.

It bears emphasizing that 15 U.S.C. § 78fff provides as follows:

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[7] The Court's statement that FDIC/FSLIC are not "debtors in title 11 bankruptcy proceedings" is both an irrelevant statement, and incorrect insofar as it implies that SIPC is such a debtor. The failed SIPC member is the debtor. § 78eee(a)(3). SIPC is the federally established and backed insurer of the failed firm's customers. SIPC is the instigator of the liquidation proceedings. SIPC is no more a "debtor" than is FDIC/FSLIC. In any event, the Court offerred absolutely no explanation of how SIPC's supposed "debtor" status should lead to a different result from the *Sharp* cases.

(b) Application of Title 11

> *To the extent consistent with the provisions of this chapter,* a liquidation proceeding shall be conducted in accordance with and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of Title 11.

(emphasis added). Although SIPA's provisions governing liquidation of firms are important, they comprise only one aspect of SIPA's overall scheme for protection of customers. Thus, the SIPA liquidation trustee may only "conduct" the liquidation using Bankruptcy Code powers if his "conduct" pursuant to those powers does not undo requirements imposed by other provisions of SIPA. It is critical to note that the policy expressed in SIPA is identical to the policy of consistency which underlies the *Sharp* cases.

In the present case, SIPA, through § 78iii and applicable SRO rules, has required SIPC members to carry the standard bond. SIPC, pursuant to its mandate under § 78iii, specifically requested the SROs to develop rules for mandatory bonding of SIPC members. The SROs responded, with SIPC's approval, by negotiating standard bonding requirements with the surety companies. Once the SROs promulgated their rules requiring the standard bond, SIPA § 78iii made those rules and those bonds mandatory for SIPC members. This history of the bonding requirement shows Congressional and SIPC approval of the bond and "all of its provisions," *California Union,* 948 F.2d at 562.

However broad SIPC's powers are under the "liquidation" provisions, they are not broad enough to allow SIPC to repudiate statutory requirements contained in other parts of SIPA itself, including the bonding requirements imposed by § 78iii. Thus, SIPC's actions in invoking 11 U.S.C. § 541 to invalidate the automatic termination provisions of the bond may be overturned without addressing the issue of whether Section 541 is "incorporated" into SIPA wholesale. Even if it was, the particular "conduct" of the SIPC trustee pursuant to section 541 is inconsistent with other provisions of SIPA.

The Eleventh Circuit, in its opinion, expressed concern about not adopting a position which would render provisions

of SIPA "essentially meaningless." *In re Government Securities Corp.*, 972 F.2d at 331. The Eleventh Circuit, however, did that very thing when it allowed SIPC to use § 78fff to override the requirements of § 78iii. The decision opens the way for SIPC and its trustees to invalidate a variety of regulatory requirements which have been imposed on SIPC members, including contracts involving the rights of third parties. This point of law – the reconciling of SIPA's liquidation provisions with its regulatory scheme – is a critical question of law which should be formally resolved by this Court.

POINT II

THE ELEVENTH CIRCUIT'S HOLDING THAT ALL OF THE BANKRUPTCY CODE PROVISIONS DESIGNATED IN SIPA § 78fff(b) ARE COMPLETELY INCORPORATED BY REFERENCE INTO SIPA CONFLICTS WITH CONTRARY STATEMENTS BY THE SECOND AND THIRD CIRCUITS ON THE SAME POINT OF LAW, AND PURPORTS TO RESOLVE AN IMPORTANT ISSUE OF FEDERAL LAW BEST RESOLVED BY THIS COURT.

The Eleventh Circuit held that the SIPC trustee could invalidate the automatic termination provisions of National Union's bond because the **anti-ipso-facto** provisions of 11 U.S.C. § 541(c)(1)(B) are incorporated by reference into SIPA by means of 15 U.S.C. § 78fff. The Eleventh Circuit's decision did not take into account the different policy objectives and structures of SIPA and the Bankruptcy Code, and the language and legislative history of the respective statutes.

Section 78fff does not incorporate all of the referenced provisions of the Bankruptcy Code. By referring only to the "conduct" of SIPA liquidation proceedings, Congress only intended to make bankruptcy procedures available in SIPA proceedings. A bankruptcy trustee's substantive rights are not incorporated *in toto*. The Eleventh Circuit's adoption of "wholesale" incorporation of all procedural and substantive

provisions of the Bankruptcy Code directly conflicts with the decisions of the Second and Third Circuits.

Next, the language and legislative history of Section 541(c)(1)(B) itself indicates that Congress did not intend to make its provisions applicable in SIPA liquidation proceedings. More important, although many provisions of SIPA and the Bankruptcy Code expressly make provisions of the Code applicable in SIPA proceedings, none refer to § 541. The extent of the Bankruptcy Code's incorporation into SIPA is an important issue of federal law which should be resolved by this Court.

A. THE PUBLIC POLICY AND PURPOSE OF SIPA DIFFERS SUBSTANTIALLY FROM THE POLICY AND PURPOSE OF LIQUIDATION UNDER THE BANKRUPTCY CODE AND THIS DIFFERENCE SUPPORTS LIMITING SECTION 541(c)(1)(B) TO A BANKRUPTCY CODE LIQUIDATION.

There is a fundamental and significant difference between liquidation proceedings under SIPA and under the Bankruptcy Code.

> The institution of a case under SIPA brings a pending bankruptcy liquidation to a halt and from that point forward, while in many respects paralleling a bankruptcy liquidation, *the liquidation proceeds separate from the Bankruptcy Code with a different primary policy orientation, that of protection of certain public customers.* For protection, such public customers through the SIPA trustee may look to the Securities Investors Protection Corporation (SIPC) for satisfaction of their claims. . . .
>
> * * *
>
> The essential difference between a liquidation under the Bankruptcy Code and one under SIPA is that under the Code the trustee is charged with converting securities to cash as quickly as possible and, with the exception of the delivery of customer name securities, making cash distributions to customers of the debtor in satisfaction of their claim. *A SIPC trustee, on the other hand, is required to distribute*

> *securities to customers to the greatest extent practicable in satisfaction of their claims against the debtor. There is, manifestly, a fundamental difference in orientation between the two proceedings. . . .* (emphasis supplied) (citations omitted)

4 Collier on Bankruptcy, Subchapter Three, Stockbroker Liquidation, Introduction 2 and 5 (15th ed. 1979).

SIPC has previously candidly recognized the distinction in its own publication:

> *"The liquidation is carried out under the special procedures of the 1970 act which, while they draw upon certain aspects of the Bankruptcy Act, are quite different in their operation from the latter Act.* These procedures give effect to the unique nature of the securities business and the intent of the Congress to make evident to investors the governmental concern with and commitment to the public interest and public confidence in our securities markets." (emphasis supplied)

SIPC's 1973 Annual Report, p. 6.

Reflecting this difference in purpose, a SIPA liquidation differs considerably in its operation from a bankruptcy proceeding. For example, in a SIPA liquidation, the court must appoint the persons that SIPC specifies as the liquidation trustee and its counsel. 15 U.S.C. § 78eee(b)(3). Customer claims in a SIPA proceeding must be filed within sixty (60) days publication of the SIPA liquidation notice, § 78fff-2(a)(3), but in a Chapter 7 bankruptcy the proofs of claim are to be filed within ninety (90) days after the first date for the section 341(a) meeting of creditors which meeting is set at a reasonable time after the order for relief. 11 U.S.C. § 341(a); Bankruptcy Rule 3002(c).

The Bankruptcy Code defines debtor as "[a] person or municipality concerning which a case under this title [Title 11] has been commenced," 11 U.S.C. § 101(12). The SIPA definition of debtor is much narrower: "a member of SIPC with respect to whom an application for a protective decree has been filed under section 5(a)(3) [15 U.S.C. § 78eee(a)(3)] or a direct payment procedure which has been instituted under section 10(b) [15 U.S.C. § 78fff-4(b)]." 15 U.S.C. § 78lll(5).

It is quite clear that a SIPA proceeding is not an ordinary bankruptcy proceeding. SIPA does not even apply the Bankruptcy Code's specific provisions for a stockbroker liquidation contained in 11 U.S.C. § 741-752. The two proceedings are entirely distinct. Thus, substantive provisions of the Bankruptcy Code such as 11 U.S.C. § 541 should not be incorporated into SIPA absent clear direction from Congress to do so.

B. SECTION 78fff(b) ONLY INCORPORATES PROCEDURAL AND JURISDICTIONAL PROVISIONS OF THE BANKRUPTCY CODE INTO SIPA, AND THE ELEVENTH CIRCUIT'S HOLDING TO THE CONTRARY CONFLICTS WITH HOLDINGS OF THE SECOND AND THIRD CIRCUITS ON THE SAME POINT OF LAW.

Section 78fff(b)'s emphasis on the "conduct" of proceedings and "consistency" shows that it only incorporates those procedural provisions of the Bankruptcy Code which are consistent with SIPA.

Courts consistently have recognized that the phrasing of § 78fff(b) does not amount to a wholesale incorporation by reference of all of the referenced provisions of the bankruptcy code:

> We note that [78fff(c)(1)][8] does not in express terms incorporate the provisions of Chapter X, but merely states that the SIPA "liquidation proceeding shall be conducted in accordance with, as as though it were being conducted under, the provisions of Chapter X. . . . "
>
> * * *
>
> Thus, § [78fff(c)(1)] is intended to make the flexible Chapter X *procedures* available for SIPA liquidations. . . . Only those provisions relating to the procedures for conducting the affairs of the estate

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[8] The cite is to SIPA prior to the 1978 amendments to the bankruptcy code and the associated change in SIPA now set forth in 78fff(b). The relevant wording of § 78fff(c)(1) is identical to the wording of § 78fff(b).

> during bankruptcy administration, except as inconsistent with the provisions of SIPA, have been incorporated.

S.E.C. v. Aberdeen Securities, Inc., 526 F.2d 603, 605 (3rd Cir. 1975) (emphasis by the court). *Aberdeen* went on to holding that Bankruptcy Act provisions for an award of attorneys fees in connection with services rendered to the estate is not incorporated into SIPA.

In *Redington v. Touche, Ross & Co.*, 612 F.2d 68 (2d Cir 1979), the court faced the issue of whether SIPA incorporated the Bankruptcy Act's provisions allowing shareholders to be heard in connection with bankruptcy proceedings. The court noted that:

> Congress' clear purpose in writing § [78fff(c)(1)] of SIPA in the manner chosen was to structure SIPA liquidations, *insofar as the SIPA court's powers with regard to jurisdiction and procedure are concerned,* on the model [of a bankruptcy court]. Thus, § [78fff(c)(1)] gives SIPA liquidation courts the procedural and jurisdictional powers conferred on a [bankruptcy court].

Id. at 71-72 (emphasis added). Although *Touche, Ross* involved jurisdictional issues and not procedural ones, the court's discussion emphasizes that the specific language used by Congress in § 78fff means that Congress has a "clear purpose" *not* to incorporate non-procedural aspects of bankruptcy law into SIPA.

Although *Aberdeen* and *Touche, Ross* were decided under SIPA and the Bankruptcy Act prior to the 1978 amendments creating the Bankruptcy Code, the reasoning of the cases is still applicable. There is no indication in the legislative history of the 1978 amendments to the Bankruptcy Code, or in the 1978 amendments to SIPA (*see* Public Law 95-598), indicating that the new substantive provisions of the Bankruptcy Code, including section 541(c)(1)(B), were to be incorporated wholesale into SIPA. The amendments to 15 U.S.C. § 78fff(b) were merely to change the cross-reference of Chapter X of the Bankruptcy Act to instead reference the new

Bankruptcy Code. Congress, presumably aware of the *Aberdeen* court's reasoning, elected to use exactly the same relevant language in § 78fff(b).

Thus, the "incorporation" inquiry in all instances must proceed on a case-by-case basis focusing on (1) whether the Bankruptcy Code provision is procedural, (2) whether the text of the provision is on its face inconsistent with SIPA, and (3) whether the "conduct" sought to be justified by the provision is inconsistent with SIPA. In the present case, the trustee's use of 11 U.S.C. § 541(c)(1)(B) does not meet the first element, and most definitely does not meet the third.

The Eleventh Circuit ignored the above case law in favor of an eyes-closed "blanket incorporation" approach:

> The plain language of § 78fff(b) makes no such [procedural-substantive] distinction, and explicitly incorporates Chapters 1, 3, 5, and subchapters I and II of Chapter 7 of the Bankruptcy Code.

972 F.2d at 330, n.1. Not only does this language directly conflict with the reasoning of the Second and Third Circuits, it ignores the careful phrasing of the statute itself.

C. 11 U.S.C. § 541(c)(1)(B) IS A SUBSTANTIVE PROVISION OF THE BANKRUPTCY CODE WHICH IS NOT INCORPORATED BY REFERENCE INTO SIPA.

The Eleventh Circuit's conclusion that section 541(c)(1)(B) applies to a SIPA liquidation proceeding is erroneous for two reasons. Section 541(c)(1)(B) clearly states, twice, that its application is limited to the commencement of a case under Title 11. Nothing in the section's legislative history supports a reading that extends its application to SIPA proceedings. Second, both SIPA and the Bankrutpcy Code explicitly designate which Code provisions are applicable in SIPA – Section 541 is not among them.

Section 541(c)(1)(B) states that:

> (c)(1) . . . [A]n interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement . . .

> (B) that is conditioned on the insolvency of financial condition of the debtor, on the *commencement of a case under this title [i.e., Title 11 U.S.C. 1, or on the appointment of or taking possession by a trustee in a case under this title [i.e., Title 11 U.S.C.*]. . . . (emphasis added)

The language of section 541(c)(1)(B) clearly and without ambiguity provides that an *ipso facto* clause triggered by a filing of a case under Title 11 is void. No mention is made of a case commenced under Title 15. If Congress had intended for section 541(c)(1)(B) to apply to a SIPA proceeding it easily could have stated "the commencement of a case under this Title or Title 15".

The legislative history of section 541(c)(1)(B) also does not support the district court's conclusion.[9] The legislative history of section 541(c)(1)(B) states as follows:

> Subsection (c) invalidates restrictions on the transfer of property of the debtor, in order that all of the interests of the debtor in property will become property of the estate. The provisions invalidated are those that restrict or condition transfer of the debtor's interest, and those that are conditioned on the insolvency or financial condition of the debtor, *on the commencement of a bankruptcy case*, or on the appointment of a custodian of the debtor's property.[10] (emphasis added)

The legislative history is completely consistent with the literal wording of the statute. Moreover, Congress had three opportunities to clearly expand section 541(c)(1)(B) to SIPA proceedings: when it was first enacted in 1978, and in the 1982 and 1984 amendments to the Bankruptcy Code. It did not do so.

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[9] Legislative History P.L. 95-598 U.S. Code Congressional and Administrative News, 95th Cong. 2d Sess., p. 5869.

[10] *Id.*

In addition, an examination of SIPA and the Bankruptcy Code specifically shows that Congress did explicitly incorporate into SIPA those substantive Code provisions which Congress deemed appropriate. By not so incorporating § 541, Congress must have intended to exclude it.

SIPA explicitly incorporates specific substantive provisions of the Code. *See* § 78eee(b)(1)(A) (adopting Code definition of insolvency in 11 U.S.C. § 101; § 78eee(b)(2)(B)(iii) (permitting trustee to abrogate right of set-off as provided in 11 U.S.C. § 553); 78fff(e) (adopting priorities of distribution in 11 U.S.C. § 726 and providing for SIPC to recoup funds as set forth in 11 U.S.C. § 507(a)(1)); and 78fff-1(b) (imposing on trustee same duties set forth in 11 U.S.C. Chapter 7). Most important to the present case, SIPA specifically incorporates the Code's powers for a trustee to avoid preferences. 11 U.S.C. § 547, and to invalidate certain transfers, 11 U.S.C. § 549. These powers are very similar in nature and purpose to that established in § 541, yet Congress specifically included these provisions in SIPA while omitting § 541. In addition, in 1982, Congress amended the "automatic stay" provision of the Code, 11 U.S.C. § 362(a), so as to make it expressly applicable in SIPA proceedings.

Thus, Congress clearly felt that 15 U.S.C. § 78fff(b) with its "conducted in accordance with" provision failed to incorporate either the automatic stay for SIPA cases, or the numerous substantive Code provisions set forth above. Section 78fff(b) is not as all-encompassing as SIPC contends.[11] All of this is consistent with the limited scope of § 78fff's careful language, as the *Aberdeen* and *Touche, Ross* cases have explained.

The Eleventh Circuit repeatedly expressed concern that § 78fff(b) would be rendered meaningless if either SIPA or

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[11] Indeed, SIPC was concerned with this omission and accordingly Theodore H. Focht, the General Counsel of SIPC, testified at the 1981 hearing of a House Sub-Committee, considering amendments to the Bankruptcy Code, in favor of amending section 362(a) to extend the automatic stay provisions to a SIPA proceeding. H.R. Report No. 97-420, 97th Cong. 2d Sess., U.S. Code Cong. and Admin. News (1982) 583, 584.

the Bankruptcy Code had to specify which substantive provisions of the Code were applicable in SIPA proceedings. Yet, ironically, *all* of the SIPA and Code provisions set forth above would have absolutely no purpose, and indeed would be totally extraneous and unnecessary, if the Eleventh Circuit's (and SIPC's) interpretation of § 78fff(b) are correct.

The Eleventh Circuit's "all or nothing" approach is inapposite. SIPA § 78fff(b) does make Bankruptcy Code provisions applicable in SIPA liquidation proceedings, but only to a limited degree and subject to specific conditions. Only procedural and jurisdictional provisions of the Code are applicable, and these must be actually applied only in a manner consistent with other provisions of SIPA. Substantive provisions of the Code will only apply where either SIPA or the Code itself so provides. Since no such language makes § 541(c)(1)(B) applicable, and since the use of § 541(c)(1)(B) to invalidate provisions of National Union's bond would be inconsistent with SIPA provisions requiring that bond, § 541(c)(1)(B) is not applicable in the present case.

CONCLUSION

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA. respectfully submits that the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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In re GOVERNMENT SECURITIES CORPORATION, *Debtor.*

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., Defendant-Appellant,

v.

John R. CAMP, Jr., Trustee, Securities Investor Protection Corporation, Plaintiffs-Appellees.

No. 90-5356.

United States Court of Appeals, Eleventh Circuit.

Sept. 14, 1992.

Appeal from the United States District Court for the Southern District of Florida.

Before TJOFLAT, Chief Judge, DUBINA, Circuit Judge, and HENDERSON, Senior Circuit Judge.

TJOFLAT, Chief Judge:

In this case, we affirm the district court's holding that the Bankruptcy Code anti-termination provision, 11 U.S.C. § 541(c)(1)(B) (1988), applies to a liquidation proceeding under the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78*lll* (1988) (SIPA), to invalidate a fidelity bond clause that purports to terminate liability under the bond automatically upon the takeover of the bonded entity by a receiver or other liquidator.

I.

The appellant, National Union Fire Insurance Company of Pittsburgh, PA. (NUFIC), issued a fidelity bond in February 1987 to the Government Securities Corporation (GSC), a securities broker, to protect it against losses resulting from, among other things, dishonest acts of its employees. Section 12(c) of the bond purports to terminate or cancel the bond "upon the taking over of [GSC] by a receiver or other liquidator."

On May 12, 1987, the Securities Investor Protection Corporation (SIPC) applied to the United States District Court for the Southern District of Florida for an order placing GSC into SIPA liquidation proceedings because of substantial shortfalls in GSC's accounts. That same day, GSC consented to the entry of an order appointing a trustee for the liquidation of its business pursuant to SIPA. The district court ordered the GSC liquidation to commence under SIPA, appointed John R. Camp, Jr. (Trustee) as trustee to administer the proceeding, and referred the case to the Bankruptcy Court for the Southern District of Florida.

On June 2, 1987, the Trustee, acting on behalf of GSC, notified NUFIC of a possible loss arising from employee dishonesty, and on December 1, 1987, filed a proof of loss. In response, NUFIC refused coverage under the bond on the ground that by virtue of section 12(c), the bond terminated on May 12, 1987, upon the appointment of the Trustee to oversee GSC's liquidation.

In August of 1988 the Trustee initiated an adversary proceeding against NUFIC within the SIPA liquidation proceeding, seeking a declaration of the rights of the

parties under the bond. The Trustee argued that NUFIC remained liable on the bond despite the commencement of the SIPA liquidation proceeding because the bond's automatic termination provision was invalidated by 11 U.S.C. § 541(c)(1)(B), the Bankruptcy Code anti-termination provision, which is made applicable to SIPA liquidation proceedings by 15 U.S.C. § 78fff(b). Section 541(c)(1)(B) forbids the courts from enforcing contract provisions that are conditioned upon the financial condition of the debtor. That section provides in relevant part:

> (c)(1) . . . an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement . . .
>
> > (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

11 U.S.C. § 541(c)(1)(B).

The Trustee argued that SIPA proceedings import this, among other Bankruptcy Code provisions, through 15 U.S.C. § 78fff(b) which provides: "To the extent consistent with the provisions of [SIPA], a [SIPA] liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of [the Bankruptcy Code]."

The bankruptcy court agreed, and accordingly entered judgment for the Trustee reasoning that:

> the Trustee's rights under the bond constitute and constituted property of the estate under Section 541 of the [Bankruptcy] Code and the automatic termination provision contained in Section 12(c) of the bond is and was ineffective by virtue of Section 541(c)(1)(B) notwithstanding the commencement of the liquidation of GSC under S.I.P.A. and the appointment of Mr. Camp as Trustee. The rights, powers, and protection given to a bankruptcy trustee by the [Bankruptcy] Code are adopted by reference into S.I.P.A., 15 U.S.C. Sections 78fff(b), 78fff-1(a).

In re Government Sec. Corp., 101 B.R. 343, 346-47 (Bankr.S.D.Fla. 1989).

NUFIC appealed the bankruptcy court's decision to the district court, and that court affirmed. The district court found that "11 U.S.C. Section 541(c)(1)(B) applies to SIPA liquidation proceedings, thereby invalidating Section 12(c), the automatic termination clause of the bond NUFIC issued to GSC." *In re Government Sec. Corp.*, 111 B.R. 1007, 1010 (S.D.Fla.1990). NUFIC then lodged this appeal. We agree with the district court and therefore affirm.

II.

The sole issue presented in this appeal is whether section 541(c)(1)(B) of the Bankruptcy Code applies in a SIPA liquidation proceeding. NUFIC makes several arguments contending that the bond provision terminating

coverage upon a takeover should not be affected by section 541(c)(1)(B). We reject them all.

First, NUFIC posits that the plain meaning of section 541(c)(1)(B) demonstrates that it does not apply in a SIPA proceeding.[1] It argues that since this section speaks only of cases commenced under title 11 and not of cases commenced under title 15,[2] this section does not apply to the latter. In effect, NUFIC argues that in order to apply to a SIPA proceeding, a Bankruptcy Code provision must state specifically that it applies.

Apart from misreading the language of section 541(c)(1)(B), this argument completely ignores section 78fff(b) which plainly states that SIPA liquidation proceedings shall be conducted in accordance with certain provisions of title 11, including Chapter 5 in which section 541(c)(1)(B) is located. NUFIC's interpretation of section 541(c)(1)(B) would render section 78fff(b) meaningless. There would be no need for section 78fff(b) if each Bankruptcy Code section that applied in a SIPA

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[1] In addition, the appellant contends that the plain meaning of § 78fff(b) of SIPA shows that § 541(c)(1)(B) of the Bankruptcy Code is not incorporated into a SIPA liquidation proceeding. NUFIC claims that § 78fff(b) incorporates only the procedural and not the substantive aspects of the Bankruptcy Code insofar as they are consistent with SIPA. This argument is entirely meritless. The plain language of § 78fff(b) makes no such distinction, and explicitly incorporates Chapters 1, 3, 5, and subchapters I and II of Chapter 7 of the Bankruptcy Code.

[2] The appellant highlights the phrases "commencement of a case under this title [title 11]," and "taking possession by a trustee in a case under this title [title 11]" in § 541(c)(1)(B) to make this argument.

proceeding had to indicate it. It is a standard rule of construction that "a court should interpret a statute so as to give effect to each of its provisions." *United States ex rel. Williams v. NEC Corp.*, 931 F.2d 1493, 1502 (11th Cir.1991) (citing *United States v. Menasche*, 348 U.S. 528, 538-39, 75 S.Ct. 513, 519-20, 99 L.Ed. 615 (1955)). We cannot construe section 541(c)(1)(B) such that section 78fff(b), an integral component of SIPA, is rendered useless. We thus agree with the lower courts in holding that section 78fff(b) specifically incorporates section 541(c)(1)(B) into a SIPA proceeding.[3]

Similarly, NUFIC contends that Congress' amending of the automatic stay provision of the Bankruptcy Code, 11 U.S.C. § 362(a), in 1982 to make it applicable upon the filing of a SIPA proceeding,[4] but neglecting to amend

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[3] This reasoning answers two other arguments that NUFIC puts forth. First, NUFIC claims that the legislative history of § 541(c)(1)(B) shows that the section was not to apply to a SIPA proceeding. They cite the Senate Report which states that "[t]he provisions invalidated are those that restrict or condition transfer of the debtor's interest, and those that are conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case, or on the appointment of a custodian of the debtor's property." S.Rep. No. 989, 95th Cong., 2d Sess. 83 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5869. This quotation does not support the weight of their argument.

Further, NUFIC asserts that the legislative history of § 541(c)(1)(B) is "in derogation of the common law," requiring the statute to be strictly construed. No matter how strictly we construe § 541(c)(1)(B), it cannot entirely negate the effect of § 78fff(b).

[4] Section 362(a) now provides:

> Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of [title

section 541(c)(1)(B) shows that Congress did not intend that section 541(c)(1)(B) apply in a SIPA proceeding. This argument too must fail. Apart from the technical reasons for section 362(a)'s amendment,[5] this argument suffers from the fatal flaw discussed above. That is, NUFIC's contention also requires each Bankruptcy Code provision specifically to state that it applies in a SIPA proceeding. We reiterate that this reasoning renders section 78fff(b) essentially meaningless, and is unacceptable.

Finally, NUFIC claims that the public policy and purpose of SIPA differ substantially from the policy and purpose of liquidation under the Bankruptcy Code. This distinction, NUFIC contends, supports the proposition that Congress intended to limit application of section 541(c)(1)(B) to a Bankruptcy Code liquidation. Specifically, the customer protection aspect of SIPA renders the proceeding so different from a proceeding in ordinary bankruptcy that section 541(c)(1)(B) cannot be deemed to apply.

> 11], or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities. . . .

11 U.S.C. § 362(a) (1988).

[5] The legislative history indicates that 11 U.S.C. § 362(a) (1988) was amended for technical clarification in order to protect further the securities consumer in the event of a brokerage house liquidation. Congress clearly meant to increase, not decrease, protection to the consumer and the availability of the Bankruptcy Code in a SIPA proceeding. *See* H.R. 420, 97th Cong., 2d Sess. (1982), *reprinted in*, 1982 U.S.C.C.A.N. 583.

This argument is inapposite to the intent of SIPA. The purpose of SIPA is to return to customers of brokerage firms their property or money. 15 U.S.C. § 78fff(a) provides that "[t]he purposes of a liquidation proceeding shall be . . . to deliver customer name securities to or on behalf of the customers of the debtor . . . ; and . . . to distribute customer property and . . . otherwise satisfy net equity claims of customers. . . . " Congress wanted more, not fewer, assets available for customers of brokerage firms in financial distress. It makes no sense to suggest that Congress intended that the SIPA trustee have less power than an ordinary bankruptcy trustee to gather assets into the debtor's estate. It is entirely consistent with SIPA that the Trustee is able to recover any claims GSC has on the bond, in addition to any monies that GSC will receive for their customers from the SIPC. The two entities as potential sources of money are not mutually exclusive, but they are different forms of insurance upon which GSC may collect, create an estate, and distribute to creditors.[6]

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[6] NUFIC also contends that as a policy matter SIPC should be considered analogous to the FDIC and FSLIC, and cites cases involving those institutions where similar bond termination clauses have been upheld. *See, e.g., Sharp v. Federal Sav. & Loan Ins. Corp.*, 858 F.2d 1042 (5th Cir.1988); *Continental Ins. Co. v. Federal Sav. & Loan Insur. Corp.*, No. CV 84-9708 AHS (C.D.Cal.1986). That analogy is inapposite; the cited cases do not involve the bankruptcy code, and those institutions are not debtors in title 11 bankruptcy proceedings.

III.

For the foregoing reasons, the order of the district court is AFFIRMED.

IT IS SO ORDERED.

UNiTED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

CASE NO. 89-1211-CIV-SPELLMAN

In re

GOVERNMENT SECURITIES CORP.,

Debtor

MEMORANDUM OPINION

JOHN R. CAMP, JR., Trustee, and the SECURITIES INVESTOR PROTECTION CORP.

(Entered March 16, 1990)

Appellees,

v.

NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA,

Appellant.

ORDER AFFIRMING BANKRUPTCY COURT

THIS CAUSE comes before the Court upon the appeal of National Union Fire Insurance Company of Pittsburgh, Pennsylvania (hereinafter "NUFIC"), from a decision of the Bankruptcy Court for the Southern District of Florida, in a declaratory judgment action brought by John R. Camp, Jr., as Trustee for the liquidation of Government Securities Corporation (hereinafter "GSC") seeking a determination of the estate's rights under a fidelity bond in light of 11 U.S.C. Section 541(c)(1)(B).

BASIS OF APPELLATE JURISDICTION

This Court has jurisdiction of this appeal pursuant to 28 U.S.C. Section 158(a).

STANDARD OF APPELLATE REVIEW

On an appeal from a proceeding pursuant to the Securities Investor Protection Act (hereinafter "SIPA") a district court is to conduct a *de novo* review of the bankruptcy court's conclusions of law. *In re Stalvey & Assocs.*, 750 F.2d 464, 468 (5th Cir. 1985). However, the bankruptcy court's "[f]indings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bankr. R. 8013.

BACKGROUND

On February 1, 1987, NUFIC issued a Securities Dealer Blanket Bond No. 959-9000 to GSC. Coverage on the bond was to commence on February 1, 1987 and continue through November 1, 1987. GSC paid the premium on the bond in full prior to its issuance.

On an application and complaint by the Securities Investor Protection Corporation (hereinafter "SIPC"), this Court (per Hastings, J.) entered an order on May 12, 1987, pursuant to 15 U.S.C. Section 78 aaa(5)(a), placing GSC, a broker-dealer in U.S. government securities, into liquidation under SIPA and appointing John R. Camp, Jr., Esq., as Trustee to administer the liquidation of GSC. This Court (per Hastings, J.) ordered the case removed to the

Bankruptcy Court for the Southern District of Florida (Cristol, J.).

On June 2, 1987, the Trustee provided written notice to NUFIC of a possible loss under the bond. Thereafter, on July 1, 1987, the Trustee brought an adversary proceeding against two employees of GSC, alleging theft of funds entrusted to them by customers of GSC. The Trustee advised NUFIC of this suit and sought information as to the proper manner of filing a loss claim under the bond.

In the normal course of business, NUFIC provides a form for its insureds to complete as part of filing a proof of loss. Despite repeated requests by the Trustee, NUFIC failed to provide such forms. NUFIC remained silent until December 23, 1987, when it informed the Trustee that coverage was denied by virtue of Section 12(c), the automatic termination clause set forth in the bond, which reads in pertinent part:

> This bond shall be deemed terminated or cancelled as an entirety:
>
> (c) immediately upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials.

As a result of NUFIC's denial of coverage, the Trustee initiated this adversary proceeding, seeking a declaration of the parties' rights under the bond in light of 11 U.S.C. Section 541 (c)(1)(B), which invalidates automatic termination provisions.

NUFIC argued that Section 541 of the Bankruptcy Code is inapplicable to SIPA liquidation proceedings based upon the plain language of that section. NUFIC

maintained that this language limits application of that section to cases arising under Title 11 (i.e. straight bankruptcy cases). In addition, NUFIC argued that the fidelity bond in question was an executory contract, and therefore subject to 11 U.S.C. Section 365(d)(1), which requires a trustee to assume or reject executory contracts within 60 days of the filing of a petition for relief in bankruptcy. NUFIC maintains that because the Trustee failed to assume the so-called executory contract by July 13, 1987 (60 days after the filing of the petition for relief), it was deemed rejected, relieving NUFIC of any liability under the bond.

On November 15, 1988, the bankruptcy court held that the adversary action was a "core proceeding" and that "[r]elevant portions of the Bankruptcy Code which prevent an automatic termination or limitation of the estate's property rights upon the filing of a bankruptcy proceeding or appointment of a trustee are applicable in this adversary matter filed in a SIPA proceeding." *In re Government Sec. Corp.*, No. 87-0245-BKC-AJC-A (Bankr. S.D. Fla. Nov. 15, 1988) (Order on National Union's: Motion for Stay of Proceedings; Motion to Dismiss Amended Complaint; Motion for Determination of Nature of Proceedings; and Motion to Abstain). On March 15, 1989, the bankruptcy court issued its findings of fact and conclusions of law. The court determined that: a) Section 541(c)(1)(B) of the Bankruptcy Code was applicable to SIPA liquidation proceedings by virtue of 15 U.S.C. Section 78 fff-1(a) which provides that "a trustee shall be vested with the same powers and title with respect to the debtor and the property of the debtor as a

trustee in a case under Title 11;" b) an automatic termination provision of the fidelity bond NUFIC issued to GSC was void and unenforceable against the Trustee by virtue of 11 U.S.C. Section 541(c)(1)(B); c) the bond was not an executory contract for purposes of 11 U.S.C. Section 365(d)(1), and therefore, the Trustee was not obligated to assume the contract by July 13, 1987, the date upon which an executory contract must have been assumed by the Trustee in order to avoid being deemed rejected pursuant to 11 U.S.C. Section 365(d)(1); and d) even if the bond were executory on May 12, 1987 (the date which the petition for relief was filed), it ceased to be executory by July 13, 1987. Thereafter, the bankruptcy court issued its final judgment from which Appellant NUFIC appeals the following holdings: a) that the adversary proceeding was a "core" matter giving the bankruptcy court jurisdiction to hear and determine the proceeding pursuant to 28 U.S.C. Section 157(b)(1); b) that 11 U.S.C. Section 541(c)(1)(B) applies to SIPA liquidation proceedings, thereby invalidating the automatic termination provision contained in Section 12(c) of the bond issued by NUFIC to GSC; and c) that the bond was not an executory contract which the Trustee was required to assume or reject within sixty days.

DISCUSSION

Nature of Proceeding

First, this Court finds that NUFIC's position that the instant action was a "non-core" proceeding to be without merit. Core proceedings are those matters which "arise under Title 11" or that "arise in a case under Title 11." 28

U.S.C. Section 157 (b)(1). Moreover, 28 U.S.C. Section 157 (b)(2)(0) states that core proceedings include, but are not limited to, "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship. . . . "

Non-core related proceedings are those matters that are traditional state law actions, not made subject to a federal rule or decision, but that are related, though only peripherally, to a pending bankruptcy case. Related matters are those non-core proceedings "that in the absence of . . . bankruptcy, could have been brought in a district court or a state court." *In re Colorado Energy Supply*, 728 F.2d 1283, 1286 (10th Cir. 1984).

11 U.S.C. Section 541 (c)(1)(B) creates substantive rights unknown at state law. Although GSC's right to recovery was pursuant to the bond, a legal right created under state law, the Trustee's ability to preserve rights under the bond exists solely under the Bankruptcy Code. Indeed, operation of Section 12(c) of the bond, the automatic termination provision, would not be an issue but for the existence of the Bankruptcy Code provision which precludes the operation of such clauses upon "insolvency, financial condition of debtor or on the commencement of a case under this title." 11 U.S.C. Section 541(c)(1)(B). As the Trustee correctly argues, this is not simply a state law contract action which, had there been no bankruptcy, could have proceeded in a state court. *In re Wood*, 825 F.2d 90, 97 (5th Cir. 1987).

Application of Section 541(c)(1)(B) could not be contemplated outside of bankruptcy, and the controversy involving payment on the bond affects the liquidation of

debtor's assets. Accordingly, this matter comes within the ambit of "core" proceedings, giving the bankruptcy court subject matter jurisdiction to hear and determine the instant case.

Application of 11 U.S.C. Section 541(c)(1)(B) to SIPA Liquidation Proceedings

Secondly, this Court finds that 11 U.S.C. Section 541(c)(1)(B) applies to SIPA liquidation proceedings, thereby invalidating Section 12(c), the automatic termination clause of the bond NUFIC issued to GSC.

The stated purposes of a SIPA liquidation proceedings are:

> (1)(B) To distribute customer property and otherwise satisfy net equity claims of customers to the extent provided in this section.
>
> * * *
>
> (4) To liquidate the business of the debtor.

15 U.S.C. Section 78fff(a).

15 U.S.C. Section 78 fff(b) provides:

> To the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under, chapters 1, 3 and 5, and subchapters I and II of Chapter 7 of Title 11. . . .

Under 11 U.S.C. Section 541 (c)(1)(B):

> . . . an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section, notwithstanding any provision-
>
> B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

This Court finds that the application of 11 U.S.C. Section 541(c)(1)(B) is consistent with the purposes of SIPA as delineated in Section 78 fff(a)(1)(B). A bankruptcy provision is "inconsistent" with SIPA if it conflicts with an explicit provision of the Act, or if application would substantially impede fair and effective operation of the Act without providing significant countervailing benefits. *SIPC v. Charisma Sec. Corp.*, 506 F.2d 1191 (2d Cir. 1974). However, a bankruptcy provision does not become "inconsistent" simply because it is not absolutely necessary for the operation of the Act. *Id.*

Application of Section 541(c)(1)(B) invalidates the automatic termination clause of the bond, thereby leaving coverage of the debtor intact. Since the purpose of the bond is to insure the debtor against dishonest acts, as occurred in the instant case, it is difficult to imagine how application of Section 541(c)(1)(B) could be deemed anything but consistent with SIPA, the purpose of which is to protect customers of securities brokerages.

NUFIC contends that Section 541(c)(1)(B) only applies to cases arising under Title 11. NUFIC cites the plain language of the statute which reads:

> " . . . on the commencement of a case under this title or on the appointment of or taking possession by a trustee in a case under this title or a custodian. . . . "

Given that the instant case arose under Title 15, NUFIC argues that Section 541 is inapplicable.

The plain language of the Bankruptcy Code indicates that while an application for liquidation is filed pursuant to Title 15 U.S.C. Section 78eee(a)(3), the liquidation process commences under Title 11 U.S.C. Section 362 of the Bankruptcy Code states in pertinent part:

> " . . . an application filed under section 5(a)(3) of SIPA operates as a stay, applicable to all entities, of – (1) the commencement or continuation . . . of process . . . or other action or proceeding . . . that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title."

Accordingly, this Court holds that Section 541(c)(1)(B) is applicable in the instant case, thereby invalidating the automatic termination provision of the bond.

Executory Contracts

11 U.S.C. Section 365(a) provides that a trustee may assume or reject any executory contract or unexpired lease of the debtor. Pursuant to Section 365(d)(1), a

trustee has sixty days after the filing of the petition for relief within which to assume or reject an executory contract. Any contract not assumed during that period is automatically deemed rejected.

The Bankruptcy Code does not define an executory contract. However, the legislative history of Section 365 states that an executory contract is one in which performance remains due to some extent on both sides. H.R. Rep. No. 595, 95th Cong., 1st Sess. 347, *reprinted in* 1978 *U.S. Code Cong. & Admin. News*, 5787, 5844. Courts have frequently held that an executory contract is one in which:

> [T]he obligations of both the bankrupt and the other party to the contract are "so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other."

Countryman, *Executory Contracts in Bankruptcy*, Part 1, 57 Minn. L. Rev. 439, 460 (1973), *cited in In re Arrow Air. Inc.*, 60 Bankr. R. 117, 120 (Bankr. S.D. Fla. 1986); *In re Charter Co.*, 52 Bankr. R. 267, 270 (Bankr. M.D. Fla. 1985).

Other courts have adopted the so-called "Functional" approach in determining whether a contract is executory. Under this approach, a court considers the purpose behind allowing the debtor or trustee to assume or reject a contract. As the court stated in *In re G-N Partners*, 48 Bankr. R. 462, 465 (Bankr. Minn. 1985), "the purpose of the provision allowing a trustee to assume or reject any executory contract or unexpired lease is to allow a trustee to pick and choose among the debtor's agreements and assume those which benefit the estate. . . . " Likewise in

In re Norquist, 43 Bankr. R. 224, 225 (Bankr. Wash. 1984), the court stated that "[r]ejection of an executory contract serves two purposes. It relieves the debtor of burdensome future obligations . . . and it constitutes a breach of contract which permits the other party to file a creditor's claim."

The bankruptcy court determined that under either the "Countryman" approach (significant performance due on both sides) or the "Functional" approach (benefit of assumption or rejection to the estate), the bond was not an executory contract. As such, the Trustee was not required to assume or reject the Bond within 60 days of filing the petition for relief. This Court finds that the bankruptcy court correctly analyzed the nature of the fidelity bond at issue in determining that it was not an executory contract.

Under the first approach, the so-called "Countryman" approach, the bond was not an executory contract because the obligations of both parties were not so far unperformed that failure of either to complete performance would constitute a material breach. There were no obligations under the bond on GSC's part for which failure to perform would constitute a material breach giving rise to a claim by NUFIC against GSC.

Under Florida law, fidelity bonds are considered to be insurance contracts, and insurance contracts have been held to be executory. *In re Evans Prods. Co.*, 91 Bankr. R. 1003 (S.D. Fla. 1988). However, the sole basis for determining that an insurance contract is executory has been the fact that the bankrupt had a continuing obligation to make premium payments under the contract. *In re Evans*,

91 Bankr. R. at 1006; *In re Pester Refining Co.*, 58 Bankr. R. 189, 191 (Bankr. S.D. Iowa 1985); *In re B. Siegel Co.*, 51 Bankr. R. 159, 161 (Bankr. E.D. Mich. 1985).

The facts of those cases differ from the instant case in one crucial respect. In the present case, the debtor paid the premium in full prior to issuance of the bond. The only remaining duties to be performed by GSC were duties necessary to initiate the filing of a claim of loss under the bond. GSC's failure to do so could not constitute a material breach giving rise to a claim by NUFIC against the estate. Rather, GSC's failure to perform those duties necessary to the filing of a claim could only benefit NUFIC, which would avoid liability to which it would otherwise be subject. Therefore, using the "Countryman" approach, the bond was not an executory contract.

Applying the second approach, the so-called "Functional" approach, the bond was not an executory contract. Under this approach, whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate. *In re Norquist*, 43 Bankr. R. at 225. Using the "Functional" approach, the bond in the instant case is clearly not executory, since rejection could not have possibly benefitted the estate. In fact, if the Court were to find that the bond was an executory contract, and thus deemed rejected by the Trustee's failure to assume, the only party to benefit from this determination would be NUFIC, which would be relieved from liability under the bond. As the bankruptcy court correctly noted, GSC, as the insured, would have given up valuable, bargained-for protection against losses. Because a finding that the bond was executory would be detrimental to

customers of GSC, such a finding would be clearly inconsistent with the stated purposes of SIPA.

Based on the above and foregoing, it is hereby

ORDERED AND ADJUDGED that the FINAL JUDGMENT of the bankruptcy court is AFFIRMED,

Done and ordered in Chambers at Miami, Florida, this 16 day of March, 1990.

/s/ Eugene P. Spellman
EUGENE P. SPELLMAN
UNITED STATES DISTRICT JUDGE

cc: all counsel of record

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF FLORIDA

(S.I.P.A. Proceeding)

Case No. 87-0910-C-KEHOE
87-0245-BKC-AJC-A

In Re:	)	
GOVERNMENT SECURITIES CORPORATION,	)	
Debtor.	)	
JOHN R. CAMP, JR., TRUSTEE,	)	
Plaintiff,	)	
v.	)	
NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,	)	ADV. NO. 88-0427-BKC-AJC-A
Defendant.	)	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

On February 1, 1989, the Court conducted a trial without a jury in the captioned proceeding. The Court has considered all of the evidence presented, facts admitted in the pleadings, and the argument of counsel. In accordance with Rule 7052 of the Bankruptcy Rules and Rule 52 of the Federal Rules of Civil Procedure, the Court

makes the following findings of fact, conclusions of law, and Order for Judgment.[1]

FINDINGS OF FACT

1. National Union Fire Insurance Company of Pittsburgh, PA., New York, New York (hereafter "NUFIC") issued a Securities Dealer Blanket Bond to Government Securities Corporation (hereafter "GSC"), which became effective on February 1, 1987 and was scheduled to expire on November 1, 1987. Amended Complaint ¶ 5; NUFIC Answer ¶ 3. The premium for the bond period, i.e., February 1, 1987 through November 1, 1987 had been paid prior to the issuance of the bond. Trial Tr. at 31, 58.

2. On May 12, 1987, the Honorable Alcee L. Hastings, as the Duty Judge, entered an order commencing the liquidation of GSC under the Securities Investor Protection Act of 1970 as amended (S.I.P.A.), 15 U.S.C. §§ 78 aaa *et seq.* in Case No. 87-910-CIV-KEHOE (S.D. Fla.). Amended Complaint ¶ 3; NUFIC Answer ¶ 3.

3. Under the terms of Judge Hastings' Order, John R. Camp, Jr. was appointed Trustee for the liquidation of GSC and the liquidation proceeding was removed to this Court. *Id;* Trial Tr. at 36.

4. By letter dated June 2, 1987, the Trustee acting on behalf of GSC, the insured, put NUFIC on notice of a possible loss under the bond. Trial Tr. at 37, 39-40, 44, 56;

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[1] Any finding of fact incorrectly denominated as a conclusion of law shall be deemed a finding of fact; any conclusion of law incorrectly denominated as a finding of fact shall be deemed a conclusion of law.

Plaintiff's Ex. 1. The Trustee's letter, which describes and attaches a copy of Judge Hastings' Order of May 12, 1987, states in part:

> In the course of our review of the files of GSC, we have determined that your firm issued a Securities Dealer Blanket Bond, which became effective on February 1, 1987. This letter is sent in accordance with the terms of Section 4 of the Bond, and is designed to serve as notice of a possible loss covered by that bond.

Plaintiff's Exhibit 1. The Trustee further advised NUFIC that his investigation would continue and he desired the maximum period of time under the bond for submission of affirmative proof of loss. *Id.* In so doing, the Trustee clearly manifested his intent to seek all available coverage afforded by the bond.

5. In response to the Trustee's letter, counsel for NUFIC advised the Trustee that it had been retained and further communications should be directed to counsel. Trial Tr. at 37-38.

6. Counsel for NUFIC thereafter conducted an investigation on behalf of NUFIC into the possible loss, and NUFIC's investigation was substantially completed on or about July 2, 1987. Trial Tr. at 30, 60.

7. In the normal course of business, NUFIC provides a form to the insured to complete as a part of the filing of a proof of loss with NUFIC. Trial Tr. at 66. Notwithstanding repeated efforts to obtain NUFIC's assistance in the filing of the proof of loss and to determine NUFIC's procedures for filing the proof of loss,

NUFIC did not provide the forms to the Trustee or his counsel. Trial Tr. at 66-67.

8. Notwithstanding the Trustee's actions, NUFIC has refused to provide coverage under the bond claiming that the bond was terminated upon appointment of the Trustee on May 12, 1987, by virtue of Section 12 (c) of the bond, the so-called automatic termination provision. Amended Complaint ¶ 7; NUFIC Answer ¶ 3; NUFIC Affirmative Defense ¶ 4. This section of the bond provides:

> Section 12. This bond shall be deemed terminated or canceled as an entirety:
>
> * * *
>
> (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials,. . . .

Id. The Securities Dealer Blanket Bond issued by NUFIC to GSC provides coverage, *inter alia*, for "loss sustained by the Insured at any time but discovered during the Bond Period. . . . " Amended Complaint, Exhibit A (opening paragraph). NUFIC takes the position that the bond terminated under Section 12 (c) of the bond upon appointment of the Trustee. Thus, NUFIC argues any discovery occurred after the bond period ceased and no coverage existed.

9. Section 12 of the bond also provides, in relevant part, that:

> This bond shall be deemed terminated or cancelled as to any Employee: (a) as soon as the Insured shall learn of any dishonest or fraudulent act on the part of such Employee. . . .

10. Under the terms of the bond, NUFIC has an obligation to pay claims made under a bond within 48 hours of a decision that the claim is clear and undisputed. Trial Tr. at 27-28. The presence of the automatic termination provision, i.e., Section 12 (c) of the bond, constitutes the principal basis for NUFIC's claim that the Trustee's claim is not clear and undisputed. *Id.* at 64.

11. By virtue of NUFIC's position on Section 12 (c) of the bond, the Trustee filed this adversary proceeding. The Trustee relies on Section 541 (c) (1) (B) of the Code, the so called *anti-ipso facto* provision, arguing:

> The basis for the declaratory relief sought by the trustee is simple. The bond and the trustee's rights under it are property of the estate, [f/n omitted] and § 541 (c) (1) (b) of the Bankruptcy Code specifically invalidates bankruptcy termination provisions which impair the trustee's property rights. [f/n omitted].

Plaintiff's Response to Defendant's Motion for Stay of Proceedings, Motion for Determination of Nature of Proceedings, Motion to Dismiss and Motion to Abstain at 14. *See also* Trial Tr. at 5.

12. In response to the Amended Complaint, NUFIC contends: a) the bond constitutes an executory contract within the meaning of Section 365 of the Bankruptcy Code; b) the Trustee did not assume the contract; c) the contract, therefore, was rejected and deemed breached under Section 365 (g) prior to the entry of Judge Hastings' Order of May 12, 1987; and d) no bond, therefore, existed after May 12, 1987 to afford coverage for a discovery made in June, 1987.

13. The validity of Section 12 (c) of the Bond must be assessed under Section 541 (c) (1) (B) if the Trustee's position is adopted. Moreover, even if Section 365, pertaining to executory contracts, is applicable, Section 12 (c) of the Bond must be considered under Section 365 (e) (1) of the Code. As stated by this Court previously, under both provisions, Section 12 (c) must fall. *See* Trial Tr. at 3-4, 71.

14. In support of its position that the contract was executory as of Monday, July 13, 1987, NUFIC offered the testimony of John J. Morrissey, bond claims counsel for NUFIC and its parent American International Group. Trial Tr. at 23-24, 47.

15. Mr. Morrissey is an attorney admitted to practice in New York. He is not admitted to practice in Florida, whose law controls the rights and obligations of the parties to the bond, except to the extent bankruptcy law applies. Mr. Morrissey is not and does not claim to be an expert on Florida law and its applicability to the bond issued by NUFIC. Mr. Morrissey testified solely on the industry's analysis of the duties imposed by the bond on NUFIC and the insured.

16. Mr. Morrissey testified that the industry and NUFIC view the bond as imposing four principal duties – two on the insured and two on the insurer. The insured must notify NUFIC of claims and advise NUFIC if the insured acquires another entity or is acquired by another entity. The insurer (NUFIC) has an obligation to investigate and to pay on a claim or deny the claim and explain the basis for the denial. Trial Tr. at 24-25, 30, 52, 54, 55. Technical requirements under the bond, which have a less

important role, include the duty by the insured to cooperate, to file proof of loss, and avoid prejudicing NUFIC's subrogation rights. Trial Tr. at 52-53, 59. Finally, the premium must be paid. *Id.* at 52, 58.

17. Mr. Morrissey admits and the Court finds that the premium was paid prior to the effective date of the bond, i.e., on or before February 1, 1987. Trial Tr. at 31, 58. By virtue of the May 12, 1987 Order placing GSC in liquidation, no obligation existed to advise NUFIC of an acquisition at that point. Trial Tr. at 25, 56. The Trustee's letter of June 2, 1987 (Plaintiff's Ex. 1), which was received shortly thereafter, satisfied the obligation to notify NUFIC of a possible loss. Trial Tr. at 56-57. The Trustee also satisfied any obligation to cooperate with NUFIC by July 2, 1987. Trial Tr. at 31, 69. Mr. Morrissey admits that the Trustee had satisfied all of his principal duties, including providing notice of a possible loss to NUFIC, and even some technical requirements of the bond by July 2, 1987. Trial Tr. at 27, 57-58.

18. In direct response to the Trustee's letter of June 2, 1987, and with the understanding that the Trustee sought to invoke the coverage of the bond, NUFIC initiated an investigation of the claim which was substantially completed by July 2, 1987.

19. By July 2, 1987, therefore, all of the principal obligations of the Trustee had been satisfied and the only obligation remaining for NUFIC was payment or denial of the claim.

20. The Order placing GSC in liquidation was entered on May 12, 1987. The Trustee did not file a motion to assume the bond under Section 365 of the

Code, if it were an executory contract, prior to Monday July 13, 1987. For the reasons set forth in the findings of fact made above, and the conclusions of law reached below, the bond was not an executory contract on May 12, 1987, and even if it were executory on that date, it ceased to be executory by July 13, 1987. Thus, there was nothing to be assumed or rejected.

CONCLUSIONS OF LAW

1. The trustee is entitled to the declaratory relief he seeks. It is beyond cavil that the Trustee's rights under the bond constitute and constituted property of the estate under Section 541 of the Code and the automatic termination provision contained in Section 12(c) of the bond is and was ineffective by virtue of Section 541(c)(1)(B) notwithstanding the commencement of the liquidation of GSC under S.I.P.A. and the appointment of Mr. Camp as Trustee. The rights, powers, and protection given to a bankruptcy trustee by the Code are adopted by reference into S.I.P.A., 15 U.S.C. Sections 78fff(b), 78fff-1(a). Fidelity bonds, like insurance policies, are among those property interests of the estate protected by the Code's anti-termination provision contained in Section 541(c)(1)(B). *See In re Gulf Tampa Drydock Co.*, 49 B.R. 154 (Bankr. M.D. Fla. 1985).

2. The statutory basis of NUFIC's contention that the Securities Dealer Blanket Bond was an executory contract is 11 U.S.C. Section 365, the Bankruptcy Code provision that deals with executory contracts and unexpired leases.

3. With exceptions not relevant here, section 365(a) provides that the trustee may assume or reject any executory contract or unexpired lease of the debtor. Pursuant to section 365(d)(1), the trustee has sixty days from the order for relief within which to assume or reject an executory contract. Any contract not assumed within that period is deemed rejected. Significantly, under section 365(g), the rejection of an executory contract by the debtor constitutes a breach of such contract and gives rise to a claim by the non-bankrupt party against the debtor's estate.

4. The Bankruptcy Code does not define an executory contract. The legislative history to section 365 states that though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides. H.R.Rep. No. 595, 95th Cong., 1st Sess. 347, repr. in 1978 U.S. Code Cong. & Admin. News 5787, 5844. In determining whether a contract is executory, the courts have frequently followed the definition of Professor Countryman who defined an executory contract as one: "under which the obligation of both the bankrupt and the other party to the contract are so far unperfected that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 460 (1973) *quoted in In re Arrow Air, Inc.*, 60 B.R. 117, 120 (Bankr. S.D. Fla. 1986); *In re Charter Co.*, 52 B.R. 267, 270 (Bankr. M.D. Fla. 1985); *In re B. Siegel Co.*, 51 B.R. 159, 161 (Bankr. E.D. Mich. 1985).

5. By logical necessity the above-cited definition of executory contract must contemplate that the performance that remains due by the debtor is such that its failure to perform would be a breach of contract which would give rise to a claim by the non-bankrupt against the debtor's estate. *See, e.g., Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (Bankr. 4th Cir. 1985), *cert. denied*, 475 U.S. 1057, 106 S.Ct. 1285, 89 L.Ed.2d 592 (1986) (holding that technology licensing agreement was an executory contract where the debtor owed the non-bankrupt continuing duties, *inter alia*, to notify of patent infringement suits and other uses of or licensing of a certain process and the non-bankrupt owed the debtor reciprocal duties of accounting for and paying royalties for use of the process); *In re Sun City Investments*, 89 B.R. 245 (Bankr. M.D. Fla. 1988) (holding that contract requiring debtor to deliver certain vehicles and convey title to certain real property to non-debtor and requiring the non-debtor to obtain a substitute mortgage on certain real property was an executory-contract); *In re Arrow Air, Inc.*, 60 B.R. 117 (Bankr. S.D. Fla. 1986) (holding that contract that imposed upon bankrupt airline the obligation to use certain types of aircraft while operating at port authority airports and upon port authority the obligation to provide the airline with access to its airports and airport services was executory).

6. A second approach to defining executory contracts is the functional approach. *See In re Arrow Air*, 60 B.R. at 121. Under the functional approach, executory contracts are measured not by mutuality of commitments but by the nature of the parties and the goals of reorganization. *See In Re Arrow Air*, 60 B.R. at 122, *citing In re*

Booth, 19 B.R. 53, 56 (Bankr. D. Utah 1982). Thus, under the functional approach, the court considers the purpose behind allowing the debtor or trustee to assume or reject a contract in determining whether or not it is executory. *Id.*[2]

7. Whether this Court adopts the Countryman definition of executory contracts or applies the functional approach to defining executory contracts in this case, it is clear that the Securities Dealer Blanket Bond issued by NUFIC to GSC was not an executory contract within the contemplation of the Bankruptcy Code.

8. The bond was not an executory contract under the Countryman definition because there were no obligations under the blanket bond on GSC's part such that its failure to perform would have been a material breach of the contract excusing NUFIC's performance and giving rise to a claim by NUFIC against the estate. It is recognized that, under Florida law, a fidelity bond is considered an insurance contract and that, in the bankruptcy context, insurance contracts are *generally* considered executory contracts. *See In re Pester Refining Co.,* 58 B.R. 189 (Bankr. S.D. Iowa 1985); *In re B. Siegel Co.,* 51 B.R. 159 (Bankr. E.D. Mich. 1985). Significantly, however, the sole basis for the holding that a contract for insurance is an

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[2] The functional approach to defining executory contracts is not entirely separate and distinct from the above-cited Countryman definition and is, in fact, actually suggested by Professor Countryman. Professor Countryman suggested that executory contracts should be defined in light of the purpose for which the trustee is given the power to assume or reject, which is to benefit the estate. Countryman, *Executory Contracts in Bankruptcy,* 57 Minn. L. Rev. 439, 450 (1973).

executory contract has been the fact that the bankrupt insured had a continuing obligation to make premium payments under the contract. *See, e.g., Pester,* 58 B.R. at 191; *B. Siegel,* 51 B.R. at 161. The holding of the cited authorities is inapplicable here because, prior to the bankruptcy, GSC made full payment and NUFIC issued the bond. Thus, the coverage that was the object of the contract had been completely obtained by GSC prior to the bankruptcy. *See In Re Placid Oil Co.,* 72 B.R. 135 (Bankr. N.D. Tex. 1987).[3]

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[3] NUFIC's reliance on *In re Evans Products Co.,* 91 B.R. 1003 (Bankr. S.D. Fla. 1988) in support of its argument that the bond in this case was an executory contract is misplaced for two reasons. First, the policy underlying the court's holding that the surety bond in *Evans* was an executory contract does not apply here. In *Evans,* the debtor needed the coverage afforded by the surety bond in order to continue its operation, operated for a period of time by virtue of the benefit it received, and then sought to avoid paying the premium for the bond. The court's holding in *Evans* in essence indicated that it would be inequitable to allow a debtor to receive the benefits of a contract without performing its duty of payment. That reasoning is not applicable in this case because, as set forth herein, GSC had made full payment for its coverage prior to bankruptcy and, therefore, does not seek to avoid any duty of payment. In fact, it is NUFIC that seeks to avoid its duty of payment for GSC's losses under the bond.

Second, there are significant differences between a surety bond, such as the one in *Evans,* and the fidelity bond issued by NUFIC which make *Evans* inapplicable here. A fidelity bond provides coverage for the insured against losses suffered by the insured as the result of the infidelity of its employees. Under a fidelity bond, the insured's primary duty is payment of the premiums. A surety bond, on the other hand, provides coverage to third parties against losses they suffer as a result of the principal's conduct. The surety's payment for losses sustained

9. The only remaining duties on GSC's part, which the Trustee satisfied, were to notify NUFIC of claims under the contract and to notify NUFIC if it acquired or was acquired by another entity. The former duty is a condition precedent to NUFIC's payment for GSC's losses. *See Bankers Ins. Co. v. Macias*, 475 So.2d 1216, 1218 (Fla. 1985); *Independent Fire Ins. Co. v. NCNB Nat'l Bank*, 517 So.2d 59, 64 (Fla. 1st DCA 1987). The latter, to the extent that it can be construed as requiring notice of an increase in hazard, is a condition subsequent to the contract. *See Independent Fire Ins.*, 517 So.2d at 64. Thus, GSC's failure to comply could not have been a material breach giving rise to a claim by NUFIC against the estate.

10. Under the functional approach to defining executory contracts it is clear that the blanket bond issued by NUFIC was not an executory contract.

11. In applying the functional approach, it is necessary to work backward, proceeding from an examination of the goals rejection is expected to accomplish. *See In re Jolly*, 574 F.2d 349, 351 (Bankr. 6th Cir.), *cert. denied*, 439 U.S. 929, 99 S.Ct. 316, 58 L.Ed.2d 322 (1978). If those purposes have already been accomplished or if they cannot be accomplished through rejection, then the contract

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by third parties creates obligation on the part of the principal to reimburse the surety for its payment. Thus, *Evans* is analogous to the cited insurance cases where the courts have held that the insured's continuing obligation to make premium payments renders the contract executory. Those authorities establish that where, as here, the insured had no obligation to make any payments, the contract is not executory.

is not executory within the meaning of the Bankruptcy Code. *Id.*

12. The purpose underlying the provision allowing the trustee or the debtor to assume or reject a contract is to benefit the estate by providing a mechanism through which severe financial burdens may be lifted. *See In re Herbert*, 806 F.2d 889, 893 (9th Cir. 1986) *citing* 2 *Collier on Bankruptcy* ¶ 365.01 (15th ed. 1986); *In Re Central Florida Fuels, Inc.*, 89 B.R. 242, 244 (Bankr. M.D. Fla. 1988); *In re Arrow Air*, 60 B.R. at 122. This purpose could not possibly have been accomplished through rejection of the contract in this case. In fact, if the contract had been rejected, precisely the opposite would have happened. GSC, as the insured, would have given up valuable, bargained-for protection against losses. The only possible benefit to be derived from GSC's rejection of the contract would have been to NUFIC. If the Court determined that the contract was an executory contract, NUFIC would be relieved of all liability on a blanket bond for which it received full payment prior to the bankruptcy. In asserting that the contract was executory, NUFIC, the non-bankrupt, is attempting to utilize to its advantage a statute designed to inure to the benefit of the bankrupt or the bankruptcy estate. In effect, NUFIC is asking the Court to use the trustee's avoidance power against the trustee. Such a result in this context is not contemplated by the Bankruptcy Code. *See In re A. H. Robins Co., Inc.*, 68 B.R. 705, 707 (Bankr. E.D. Va. 1986).

13. Accordingly, this Court concludes that the Securities Dealer Blanket Bond issued by NUFIC to GSC is not an executory contract that was capable of being assumed or rejected by the trustee. The trustee's failure to assume

the contract within the period prescribed by the Code will, therefore, not be deemed a rejection of the contract that relieves NUFIC of its obligation to provide coverage for the possible loss reported by the trustee on June 2, 1987.

14. Even if this Court were to determine that the bond was an executory contract at the time of the commencement of the bankruptcy proceedings, NUFIC would not be relieved of its obligation to provide coverage for the possible loss reported on June 2, 1987.

15. The critical date for determining the executory nature of a contract is the date on which the bankruptcy court considers the debtor's application to assume or reject the contract. *In re Pesce Baking Co., Inc.*, 43 B.R. 949, 957 (Bankr. N.D. Ohio 1984), *citing Gloria Mfg. v. International Ladies Garment Workers*, 734 F.2d 1020 (4th Cir. 1984), *In re Total Transp. Serv., Inc.*, 37 B.R. 904, 11 B.C.D. 872 (Bankr. S.C. Ohio 1984). Although a contract may be executory on the date the bankruptcy petition is filed, *see In re Pesce*, 43 B.R. at 457, circumstances may arise which render the contract no longer executory. For example, if the agreement expires of its own terms before the bankruptcy court considers the application to assume or reject the contract, the application becomes moot as there is no longer anything to assume or reject. *Id.*

16. Thus, if the bond in this case were executory at the time of the commencement of the bankruptcy proceedings, but expired of its own terms (i.e., the expiration/renewal date was reached) a few days later, there would have been nothing for the trustee to assume or reject on the sixtieth day and any motion for assumption

or rejection would have been deemed moot. The same analysis is true in the instant case.

17. In this case, the bond specifically provided that it shall be deemed terminated or cancelled as to any employee as soon as the insured shall learn of any dishonest or fraudulent act on the part of such employee.[4] The trustee reported the possible loss in June, 1987. As of the date of discovery, the bond, by its own terms, was terminated or cancelled as to those employees. Thus, on the sixtieth day, i.e., July 13, 1987, any application to assume the contract would have been deemed moot as to coverage for the employees whose acts gave rise to the loss under the bond.

18. To the extent Section 365 had some applicability, Section 12(c) of the bond is and was ineffective under Section 365(e)(1) notwithstanding the commencement of the liquidation of GSC under S.I.P.A. and the appointment of Mr. Camp as Trustee. Insurance policies are among those property interests of the estate protected by the Code's anti-termination provision. *See e.g., In re Garnar,* 31 B.R. 221 (Bankr. D. N.D. 1984). The rights and powers accorded to the trustee by the Code are adopted by reference into S.I.P.A., 15 U.S.C. §§ 78fff(b), 78fff-1(a).

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[4] This automatic termination provision, unlike the provision in Section 12(c) of the bond, remained unaffected by Section 541(c)(1)(B) or 365(e)(1) because it was not conditioned on insolvency of the debtor, commencement of the liquidation, or the appointment of a Trustee.

Thus, the trustee in this case is entitled to the protection afforded by Section 365(e)(1) of the Code.[5]

19. Judgment shall be entered accordingly.

Dated: at Miami, Florida this 15 day of March, 1989.

A. JAY CRISTOL
A. JAY CRISTOL
Bankruptcy Judge

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[5] By virtue of the foregoing findings of fact and conclusions of law, Plaintiff's Motion for Judgment on the Pleadings is rendered moot.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF FLORIDA

(S.I.P.A. Proceeding)

Case No. 87-0910-C-KEHOE
87-0245-BKC-
AJC-A

In Re: GOVERNMENT SECURITIES CORPORATION, Debtor.	ADV. NO. 88-0427-BKC-AJC-A
JOHN R. CAMP, JR., TRUSTEE, Plaintiff, v. NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., Defendant.	

FINAL JUDGMENT

This action came on for trial on February 1, 1989 before the Court, Honorable A. Jay Cristol, Bankruptcy Judge, presiding. The issues having been duly tried and a decision and findings of fact and conclusions of law having been duly rendered,

It is Ordered, Adjudged, and Decreed that:

1. The plaintiff, John R. Camp, Jr., Trustee is entitled to a declaration of his rights under the Securities Dealer

Blanket Bond ("the bond") issued by the National Union Fire Insurance Company of Pittsburgh, PA to Government Securities Corporation;

2. Section 12(c) of the bond provides:

> This bond shall be deemed terminated or cancelled as an entirety immediately upon the taking over of the insured by a receiver or other liquidation by state or federal officials;

3. The Trustee in this case is entitled to the protection afforded by Title 11 of the United States Code against the termination clause, i.e., Section 12(c) of the bond. 15 U.S.C. §§ 78fff(b); 78fff-1(a);

4. Section 12(c) of the bond is void and unenforceable against the Trustee by virtue of 11 U.S.C. § 541(c)(1)(B);

5. The bond was not an executory contract within the meaning of 11 U.S.C. § 365 as of May 12, 1987, but even if it were, the contract ceased to be executory prior to July 13, 1987. Similarly Section 12(c) of the bond is void and unenforceable against the Trustee under 11 U.S.C. § 365(e)(1).

Done and Ordered at Miami, Florida on this 15th day of March, 1989.

A. JAY CHISTOL
A. JAY CRISTOL
Bankruptcy Judge

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¶2181 Securities "Failed to Receive" and "Failed to Deliver"

¶2181A APPENDIX B

(a) No member, or person associated with a member, shall sell a security for his own account, or buy a security as a broker for a customer (except exempt securities), if,

(1) in respect to domestic securities, he has a fail to deliver in that security 60 days old or older; or

(2) in respect to foreign securities, he has a fail to deliver in that security 90 days old or older (except American Depositary Receipt and Canadian securities, which shall be subject to the provisions of paragraph (1)).

(b) For good cause shown and in exceptional circumstances, a member may request exemption from the provisions of this rule by written request to the District Director of the District in which his principal office is located.

[Sec. 31 added effective September 24, 1973.]

¶ 2182 Fidelity Bonds

Sec. 32.

Application

(a) Every member shall be required to carry a blanket fidelity bond meeting requirements as to form, amount and type of coverage as the Board of Governors may prescribe pursuant to the authorization granted by paragraph (b) hereof.

Authority of Board

(b) The Board of Governors is hereby authorized to adopt rules, regulations and procedures for blanket fidelity bonds concerning the form, amount and type of coverage thereof. The rules, regulations and procedures authorized hereby shall be incorporated into Appendix C to be attached to and made part of this rule. The Board of Governors shall have the power to alter, amend, supplement or modify the provisions of Appendix C from time to time without recourse to the membership for approval, as would otherwise be required by Article VII of the By-Laws. All contemplated changes shall, however, be submitted to the membership for comment prior to effectiveness. Appendix C shall become effective as the Board of Governors may prescribe unless disapproved by the Securities and Exchange Commission.

¶ 2182A **APPENDIX C**

Coverage Required

(a) Each member required to join the Securities Investor Protection Corporation who has employees and who is not a member in good standing of the American Stock Exchange, Inc., the Boston Stock Exchange, the Midwest Stock Exchange, Inc., the New York Stock Exchange, Inc., the Pacific Stock Exchange, Inc, the Philadelphia Stock Exchange, Inc., or the Chicago Board Options Exchange shall:

(1) Maintain a blanket fidelity bond, in a form substantially similar to the standard form of Brokers Blanket Bond promulgated by the Surety Association of America,

covering officers and employees which provides against loss and has agreements covering at least the following:

(a) Fidelity

(b) On Premises

(c) In Transit

(d) Misplacement

(e) Forgery and Alteration (including check forgery)

(f) Securities Loss (including securities forgery)

(g) Fraudulent Trading

(h) Cancellation Rider providing that the insurance carrier will use its best efforts to promptly notify the National Association of Securities Dealers, Inc. in the event the bond is cancelled, terminated or substantially modified.

(2) Maintain minimum coverage for all insuring agreements required in this subsection (a) of not less than $25,000;

(3) Maintain required minimum coverage for fidelity, On Premises, In Transit, Misplacement and Forgery and Alteration insuring agreements of not less than 120% of its required net capital under Rule 15c3-1 up to $600,000. Minimum coverage for required net capital in excess of $600,000 shall be determined by reference to the following table:

Net Capital Requirement under Rule 15c3-1	Minimum Coverage
$ 600,001– 1,000,000	750,000
1,000,001– 2,000,000	1,000,000
2,000,001– 3,000,000	1,500,000
3,000,001– 4,000,000	2,000,000
4,000,001– 6,000,000	3,000,000
6,000,001–12,000,000	4,000,000
12,000,001–and above	5,000,000

(4) Maintain Fraudulent Trading coverage of not less than $25,000 or 50% of the coverage required in subsection (a)(3), whichever is greater, up to $500,000;

(5) Maintain Securities Forgery coverage of not less than $25,000 or 25% of the coverage required in subsection (a)(3), whichever is greater, up to $250,000.

Deductible Provision

(b)(1) A deductible provision may be included in the bond of up to $5,000 or 10% of the minimum insurance requirement established hereby, whichever is greater.

(2) If a member desires to maintain coverage in excess of the minimum insurance requirement then a deductible provision may be included in the bond of up to $5,000 or 10% of the amount of blanket coverage provided in the bond purchased, whichever is greater. The excess of any such deductible amount over the maximum permissible deductible amount described in paragraph (b)(1) above must be deducted from the member's net

worth in the calculation of the member's net capital for purposes of Rule 15c3-1 under the Securities Exchange Act of 1934. Where the member is a subsidiary of another NASD member the excess may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

Annual Review of Coverage

(c)(1) Each member, other than members covered by subsection (c)(2) herein, shall annually review, as of the anniversary date of the issuance of the bond, the adequacy thereof by reference to the highest required net capital during the immediately preceding twelve-month period, which amount shall be used to determine minimum required coverage for the succeeding twelve-month period pursuant to subsections (a)(2), (3), (4) and (5) herein.

(2) Each member which has been in business for one year shall, as of the first anniversary date of the issuance of its original bond, review the adequacy thereof by reference to an amount calculated by dividing the highest aggregate indebtedness it experienced during its first year by 15. Such amount shall be used in lieu of required net capital under Rule 15c3-1 in determining the minimum required coverage to be carried in the member's second year pursuant to subsections (a)(2), (3), (4) and (5) herein. Notwithstanding the above, no such member shall carry less minimum bonding coverage in its second year than it carried in its first year.

(3) Each member shall make required adjustments not more than sixty days after the anniversary date of the issuance of such bond.

Notification of Change

(d) Each member shall report the cancellation, termination or substantial modification of the bond to the Association within ten business days of such occurrence.

Definitions

(e) For purposes of fidelity bonding the term "employee" or "employees" shall include any person or persons associated with a member firm (as defined in Article I, Section 3(m) of the By-Laws) except:

(1) Sole Proprietors

(2) Sole Stockholders

(3) Directors or Trustees of member firms who are not performing acts coming within the scope of the usual duties of an officer or employee.

[Section 32 added effective March 15, 1974; last amended effective July 11, 1979; November 19, 1982.]

§ 78iii. Functions Of Self-Regulatory Organizations

* * *

(c) INSPECTIONS. – The self-regulatory organization of which a member of SIPC is a member or in which it is a participant shall inspect or examine such member for compliance with applicable financial responsibility rules, except that –

> (1) if the self-regulatory organization is a registered clearing agency, the Commission may designate itself as responsible for the examination of such member for compliance with applicable financial responsibility rules; and
>
> (2) if a member of SIPC is a member of or participant in more than one self-regulatory organization, the Commission, pursuant to section 78q(d) of this title, shall designate one of such self-regulatory organizations or itself as responsible for the examination of such member for compliance with applicable financial responsibility rules.

(d) REPORTS. – There shall be filed with SIPC by the self-regulatory organizations such reports of inspections or examinations of the members of SIPC (or copies thereof) as may be designated by SIPC by bylaw or rule.

(e) CONSULTATION. – SIPC shall consult and cooperate with the self-regulatory organizations toward the end:

> (1) that there may be developed and carried into effect procedures reasonably designed to detect approaching financial difficulty upon the part of any member of SIPC;

(2) that, as nearly as may be practicable, examinations to ascertain whether members of SIPC are in compliance with applicable financial responsibility rules will be conducted by the self-regulatory organizations under appropriate standards (both as to method and scope) and reports of such examinations will, where appropriate, be standard in form; and

(3) that, as frequently as may be practicable under the circumstances, each member of SIPC will file financial information with, and be examined by, the self-regulatory organization which is the examining authority for such member.

* * *

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§ 78fff. General Provisions Of A Liquidation Proceeding

(a) PURPOSES. – The purposes of a liquidation proceeding under this chapter shall be –

(1) as promptly as possible after the appointment of a trustee in such liquidation proceeding, and in accordance with the provisions of this chapter –

(A) to deliver customer name securities to or on behalf of the customers of the debtor entitled thereto as provided in section 78fff-2(c)(2) of this title; and

(B) to distribute customer property and (in advance thereof or concurrently therewith) otherwise satisfy net equity claims of customers to the extent provided in this section;

(2) to sell or transfer offices and other productive units of the business of the debtor;

(3) to enforce rights of subrogation as provided in this chapter; and

(4) to liquidate the business of the debtor.

(b) APPLICATION OF TITLE 11. – To the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of Title 11. For the purposes of applying such title in carrying out this section, a reference in such title to the date of the filing of the petition shall be deemed to be a reference to the filing date under this chapter.

* * *

SUBCHAPTER III

The Estate

SECTION 541 (11 U.S.C. § 541)

§ 541. Property of the estate.

* * *

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law –

* * *

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

* * *

Supreme Court, U.S.
FILED
JAN 25 1993
OFFICE OF THE CLERK

No. 92-1046

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,

Petitioner,

vs.

JOHN R. CAMP, JR., TRUSTEE, and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

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BRIEF OF RESPONDENTS IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

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COUNTERSTATEMENT OF THE QUESTION PRESENTED FOR REVIEW

Petitioner National Union Fire Insurance Company of Pittsburgh, PA. ("NUFIC") issued a fidelity bond to the Government Securities Corporation ("GSC" or "Debtor"), a securities broker-dealer, to protect it against damages resulting, among other things, from dishonest acts of its employees. Unfortunately, dishonest acts took place, causing damages in excess of the $500,000 bond limit. The fidelity bond contained a provision automatically terminating the bond upon a "taking over of the Insured by a receiver or other liquidator. . ." ("the termination clause"). NUFIC conceded that were the liquidation proceeding purely under the Bankruptcy Code, section 541(c)(1)(B) of the Code, 11 U.S.C. §541(c)(1)(B), would have invalidated the termination clause and hence made NUFIC liable. But NUFIC argued that section 541(c)(1)(B) did not apply because the liquidation proceeding was initiated under the Securities Investor Protection Act, 15 U.S.C. §78aaa *et seq.* ("SIPA").* Thus, the issue presented is

> Whether 11 U.S.C. section 541(c)(1)(B) applies in a liquidation proceeding under SIPA where SIPA section 78fff(b) requires that: "[t]o the extent consistent with the provisions of [SIPA], a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of Title 11;" where section 541(c)(1)(B) is contained in chapter 5 of Title 11; and where there is no inconsistency between the provisions of SIPA and that section.

---

* For convenience, references herein to provisions of SIPA shall be to the United States Code, and hereinafter shall omit "15 U.S.C."

LIST OF PARTIES

The parties to the proceeding before the United States Court of Appeals for the Eleventh Circuit are as stated by the petitioner, except that the name of the Trustee herein is John R. Camp, Jr., and not John H. Camp, Jr. In addition, the law firm of Adorno & Zeder, P.A., is a party.**

The Securities Investor Protection Corporation ("SIPC") is created pursuant to a federal statute, and has no parent companies or subsidiaries.***

** Neal B. Shniderman, Esquire, formerly an attorney with the law firm of Blackwell & Walker, P.A., was the Trustee's lead counsel in this case. On April 1, 1992, having terminated his relationship with that firm, Mr. Shniderman became a member of the law firm of Adorno & Zeder, P.A. In order for Mr. Shniderman to be able to continue to represent him, the Trustee thereafter obtained Bankruptcy Court permission to engage Adorno & Zeder, P.A., as special counsel, in part, for purposes of this litigation.

*** SIPC's participation in this matter has been pursuant to SIPA section 78eee(d). In pertinent part, under that provision, SIPC is a party in interest as to all matters arising in a SIPA liquidation proceeding, "with the right to be heard on all such matters."

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-1046

NATIONAL UNION FIRE INSURANCE CO.
OF PITTSBURGH, PA.,

Petitioner,

VS.

JOHN R. CAMP, JR., TRUSTEE,
and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

BRIEF OF RESPONDENTS IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI

SUMMARY OF ARGUMENT

This Court should not grant the petition for a writ of certiorari for the following reasons:

1. There is no conflict between the decision of the Eleventh Circuit and that of any other court of appeals. Every court addressing the issue of whether section 541(c)(1)(B) of the Bankruptcy Code invalidates the termination clause in a fidelity bond in a SIPA case has held that it does. The cases cited by NUFIC in an attempt to create a conflict are irrelevant. Those cases, in which the termination clauses were contained in fidelity bonds issued to thrifts and a bank, involve different facts, different insured institutions, and above all, different statutes. None of the statutes in those cases contain a provision comparable to section 541(c)(1)(B).

2. There is no conflict regarding the applicability under SIPA section 78fff(b), of substantive, as well as procedural, provisions of the Bankruptcy Code to SIPA proceedings. The two cases relied upon by NUFIC present no genuine conflict and are distinguishable. Neither one addressed the substantive versus procedural distinction made here, and both construed an early version of section 78fff(b). Since then, the language of section 78fff(b) has been clarified, and both its language and legislative history make clear that the only circumstance in which a Title 11 provision will not apply, is if it is inconsistent with SIPA.

3. Whether or not the insurance agreement should be enforced is significant only to the parties involved, and has no importance beyond the confines of this case. The arguments made by NUFIC, founded as they are on misstatements of the law, the issue, and "facts" not raised by it in any court below, clearly present no issue worthy of review.

ARGUMENT

The underlying adversary proceeding was brought within the context of a liquidation proceeding under SIPA. This Court discussed the nature of a SIPA proceeding in general terms in *SIPC v. Barbour*, 421 U.S. 412, 415-417 (1975). However, in *Barbour*, the Court was not concerned with an actual liquidation proceeding of a bankrupt stockbroker, but rather with the question of whether a private right of action existed to compel SIPC to commence such a proceeding. Because an understanding of the nature of the proceeding is critical to a proper resolution of the petition in this case, the history of SIPA, as well as its purposes and relevant provisions, are examined briefly below. That examination reveals that at bottom, the SIPA proceeding is no more than an ordinary bankruptcy liquidation case, with special customer protection features superimposed on it.

Nature of a SIPA Proceeding: Its History and Purposes

Prior to 1938, customers of a bankrupt stockbroker were considered as general creditors if they could not reclaim

cash or securities which they could trace into the broker's possession. *Duel v. Hollins*, 241 U.S. 523, 527-29 (1916). Because serious inequities could and did result from this method of reclaiming, Congress enacted section 60(e) of the Bankruptcy Act in 1938.

A. Section 60(e) of the Bankruptcy Act

Section 60(e) of the former Bankruptcy Act, 11 U.S.C. §96(e) (repealed 1979), permitted "cash customers," as defined therein, to reclaim fully paid securities which were "specifically identifiable" as their property. 11 U.S.C. §96(e)(4) (repealed 1979). Otherwise, customers' cash, securities or property of a similar character generally constituted a "single and separate fund" to be applied in satisfaction of customers' claims on a *pro rata* basis, subject only to prior payment of certain administrative expenses. 11 U.S.C. §96(e)(2) (repealed 1979). As for the unpaid balance of their net equities, customers shared with general creditors in the general estate. A more detailed discussion of section 60(e) is contained in 3 *Collier on Bankruptcy*, ¶¶60.71-60.76 (14th ed. 1977).

Because of the usually inadequate single and separate fund, section 60(e) did not prevent customer losses. Customer exposure mounted when the rate of stockbroker failures accelerated in the 1960s. Congress responded to the crisis by enacting SIPA. S. Rep. No. 1218, 91st Cong., 2d Sess. 4 (1970) ("S. Rep. No. 1218"). *See also* H.R. Rep. No. 1613, 91st Cong., 2d Sess. 1 (1970) ("H.R. Rep. No. 1613"), *reprinted in* 1970 U.S. CODE CONG. & ADM. NEWS at 5255; *SIPC v. Barbour*, *supra*, 421 U.S. at 415.

B. SIPA

With some adjustments, SIPA expressly continued the substantive scheme of section 60(e).[1] The major impact of SIPA on customer recoveries was to reduce losses by providing a limited back-up of the single and separate fund through SIPC funds. In essence, SIPA improved "collectability" while adhering to the section 60(e) philosophy of

[1] S. Rep. No. 1218 at 11; H.R. Rep. No. 1613 at 1.

according customers limited preferential rights based on their actual securities and cash positions entrusted to the broker.

In 1978, SIPA was amended to provide greater flexibility to SIPC in satisfying customer claims in an expeditious fashion.[2] The essential elements of a SIPA proceeding remained unchanged.

C. The SIPC Fund

SIPA requires SIPC to establish a fund via assessments upon its members. §78ddd(a)(1). If SIPC's funds should become inadequate, SIPA authorizes a borrowing against the U.S. Treasury of up to one billion dollars. §78ddd(f)-(h). These resources are available for the satisfaction of customer claims within certain limits.

D. Use of SIPC Funds to Satisfy Customer Claims

SIPA requires the distribution of "a quasi-public fund." *SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 980 (2d Cir. 1974). "SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customers." *Id.* at 983.

Under section 78fff-3(a), SIPC is authorized to advance to the trustee, in order to satisfy net equity claims of customers, up to $500,000 per customer of which no more than $100,000 may be used to satisfy a claim which is for cash rather than for securities. Regardless of the assets of the failed firm, each eligible customer with a valid claim is assured of satisfaction within the limits indicated. However, SIPA does not attempt to make all customers whole and SIPC's role is carefully delineated. It contemplates that customers' claims will be satisfied to the maximum extent possible from the assets of the defunct member firm. Thus, customers share on a *pro rata* basis in any fund of customer property and any general estate. SIPA

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[2] SIPA has been amended by Pub. L. No. 95-283, 92 Stat. 249 (1978); Pub. L. No. 95-598, 92 Stat. 2549 (1978); Pub. L. No. 96-433, 94 Stat. 1855 (1980); and Pub. L. No. 97-303, 96 Stat. 1409 (1982).

§78fff-2(c)(1). SIPC's funds supplement those assets within the limits and in the manner provided by the statute. The availability of SIPC's funds does not lessen the burden of customer claims on the estate or its general creditors. To the extent of its advances, SIPC is subrogated to the claims of such customers. SIPA §78fff-3(a). *See SIPC v. Associated Underwriters, Inc.*,423 F.Supp. 168, 170-173 (D. Utah 1975).

E. Bankruptcy Nature of a SIPA Proceeding

Except for the fact that the statutory protection is not "insurance," *SIPC v. Associated Underwriters, Inc., supra,* 423 F.Supp. at 171, 173, it is useful to consider SIPA, as one court has, as an "engraftment of insurance provisions upon the preexisting Section 60(e) bankruptcy provisions applicable to stockbrokers. . . ." *SEC v. Aberdeen Securities Co.*, 480 F.2d 1121, 1123 (3d Cir.), *cert. den. sub nom., Seligsohn v. SEC*, 414 U.S. 1111 (1973). Thus, notwithstanding the special protection afforded customers, a proceeding under SIPA essentially is a bankruptcy liquidation. See, *e.g., SIPC v. Ambassador Church Finance/Development Group, Inc.*, 788 F.2d 1208, 1210 (6th Cir.), *cert. den. sub nom., Pine Street Baptist Church v. SIPC*, 479 U.S. 850 (1986); *SEC v. Albert & Maguire Sec. Co.*, 560 F.2d 569, 572 (3d Cir. 1977); *Exchange National Bank v. Wyatt*, 517 F.2d 453, 457-459 (2d Cir. 1975). Indeed, one of the stated goals of the proceeding is "to liquidate the business of the debtor." SIPA §78fff(a)(4). If the court grants the application by SIPC to commence a SIPA proceeding, it appoints a trustee to administer the liquidation and removes the proceeding to the bankruptcy court for that district. §§78eee(b)(3) and (b)(4). To the extent consistent with SIPA, the SIPA proceeding is to "be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7" of the Bankruptcy Code. §78fff(b).

As discussed in greater detail, *infra,* because the SIPA proceeding effectively is a bankruptcy proceeding, it looks not only to the disposition of claims of customers, but also

to the claims of general creditors. The trustee is responsible not only to customers but to the entire bankruptcy estate and all of its creditors.

I. BECAUSE THE THRIFT AND BANK CASES DO NOT INVOLVE THE BANKRUPTCY CODE, THERE IS NO CONFLICT.

NUFIC's petition contains many misstatements, only one of which is its misstatement of the issue. Whether or not the federal government selectively may invalidate a provision of a government-approved fidelity bond which it requires of a company subject to its regulation and which has been issued to that company is not a question presented under the facts of this case. Cert. Pet. at 3.[3] SIPC is "not an agency or establishment of the United States Government." SIPA §78ccc(a)(1)(A). Moreover, as discussed *infra*, the bond was not required by SIPA, and SIPC had no authority to, and in fact, did not, negotiate, adopt, or approve of, the termination clause. In view of the foregoing, how courts have answered the question framed by NUFIC is unimportant. What is important is that every court that has considered the question which *is* at hand, namely, whether 11 U.S.C. section 541(c)(1)(B) invalidates the termination clause of a fidelity bond issued to a debtor in a SIPA proceeding, has answered it in the affirmative. Those courts have included the bankruptcy and district courts, and the court of appeals in the instant GSC case, as well as the Bankruptcy and District Courts for the Middle District of North Carolina in another SIPA case.[4]

Notwithstanding the foregoing, in an effort to create a conflict where none exists, NUFIC relies upon three circuit

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[3] References hereinafter to NUFIC's Petition for Writ of Certiorari shall be to "Cert. Pet."

[4] *In re Waddell Jenmar Securities, Inc. (SIPC, Trustee v. NUFIC)*, Case No. A-89-0068, Adv. Pro. No. 90-2149 (Bankr. M.D.N.C. Feb. 18, 1992), *affirmed* (M.D.N.C. Aug. 12, 1992). NUFIC has appealed the decision of the district court. *In re Waddell Jenmar Securities, Inc. (SIPC, Trustee v. NUFIC)*, No. 92-2158 (4th Cir.).

court decisions ("the thrift and bank cases") which it asserts are at odds with the decision of the Eleventh Circuit. Ultimately, those cases, which involve different industries and facts, are irrelevant because they involve different statutes.

1. The Cases Relied Upon by NUFIC Are Irrelevant.

Although NUFIC attempts to draw parallels between the GSC and thrift and bank cases, it omits one critical factor that clearly sets them apart. Contrary to the situation at hand, section 541(c)(1)(B) of the Bankruptcy Code did not apply in any of the cases cited by NUFIC. Two of the cases involved savings and loan associations ("S&Ls") as to which the Federal Home Loan Bank Board ("FHLB") had appointed the Federal Savings and Loan Insurance Corporation ("FSLIC") conservator or receiver. *California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556 (9th Cir. 1991), and *Sharp v. FSLIC*, 858 F.2d 1042, 1043 (5th Cir. 1988) ("*Sharp*"). Under 12 U.S.C. section 1464(d)(6)(A) and (B) (1988), and 12 C.F.R. sections 547.2 and .3 (1988), the FHLB had exclusive jurisdiction and power to appoint the FSLIC as receiver or conservator for an S&L "without requirement of notice, hearing, or other action." In short, an S&L would be placed in conservatorship without reference to any bankruptcy proceeding. Likewise, in *FDIC v. Aetna Cas. and Sur. Co.*, 903 F.2d 1073, 1074 (6th Cir. 1990), the Federal Deposit Insurance Corporation ("FDIC") was appointed receiver for a bank by the Tennessee Commissioner of Banking. See 12 U.S.C. §1821(c) (1989). In the cases cited by NUFIC, neither the bank nor the S&Ls were in liquidation under Title 11. For that matter, they could not have been because banks and thrifts, including S&Ls, may not be debtors under Title 11. See 11 U.S.C. §109(b)(2) (1992). As provided in the legislative history of the Bankruptcy Reform Act of 1978, and as NUFIC concedes, "[b]anking institutions . . . are excluded from liquidation under the bankruptcy laws because they are bodies for which alternate provision is made for their liquidation under various State or Federal regulatory laws." S. Rep.

No. 989, 95th Cong., 2d Sess. at 31 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADM. NEWS 5817. See Cert. Pet. at 18 ("It is true that FDIC/FSLIC liquidation proceedings do not rely on the provisions of the bankruptcy code."). Accordingly, section 541(c)(1)(B) has no place in a bank or thrift liquidation.

In contrast, and as discussed *infra*, section 541(c)(1)(B) applies to SIPA proceedings by reason of SIPA section 78fff(b). Because section 541(c)(1)(B) governs the liquidation of stockbrokers but not of banks and thrifts, the cases cited by NUFIC are irrelevant, and do not conflict with the decision of the Eleventh Circuit.[5]

2. No Basis Exists to Apply Banking Law to the Liquidation of a Securities Broker-Dealer.

A. NUFIC's Erroneous Assertions Are Untimely Raised.

In the Bankruptcy Court, NUFIC relied upon the district court decision in *Sharp* and on another thrift case not cited by it here, for the limited proposition that termination clauses in those cases had been upheld. NUFIC Mem. of Law, certified as served on Sept. 19, 1988, at 8-10. On appeal to the District Court and the Eleventh Circuit, over the Trustee's and SIPC's objections as to timeliness (see Joint Brief at 25, n.13), it added a new argument, namely, that SIPC should not be allowed "to substantially impair the express terms of a bargained for contract between the insurer and the insured," because by

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[5] The fact that Congress has articulated a different policy in the banking area is evident from its enactment of 12 U.S.C. section 1821(e)(12)(A). Under that section, a bank conservator or receiver is prohibited from enforcing a fidelity bond. See *FDIC v. Aetna Cas. and Sur. Co.*, *supra*, 903 F.2d at 1078. Thus, while Congress has expressed its intent in 11 U.S.C. section 541(c)(1)(B), that trustees recover under such bonds in stockbroker liquidations, it has expressed a different intent under 12 U.S.C. section 1821(e)(12)(A), by denying their enforcement to bank receivers or conservators. For a recent discussion of the differences between the FDIC and SIPC, see GAO, *The Regulatory Framework Has Minimized SIPC's Losses* (Sept. 1992) at 15-16.

analogy to *Sharp*, SIPC allegedly required its members to obtain the bond in the first place, and "could require its members to purchase an additional discovery period available to a SIPC Trustee in the event of a takeover." District Court Brief of NUFIC, at 16. In its certiorari petition, it raises yet another erroneous argument, namely, that the termination clause should be enforced because SIPC "accepted this standard [fidelity] bond as drafted." Cert. Pet. at 17.

This Court should decline to consider the latter arguments because they either were never raised or were not timely raised below. In particular, NUFIC's belated and false assertion as to SIPC's supposed approval of the termination clause underscores why review is inappropriate. Whether or not SIPC approved of the termination clause raises questions of fact. Yet, NUFIC introduced no evidence, and the Trustee and SIPC countered with none because the question was never raised. As observed in *Singleton v. Wulff*, 428 U.S. 106, 120 (1976), there are sound reasons for a refusal to consider such issues:

> It is the general rule, of course, that a federal appellate court does not consider an issue not passed upon below. In *Hormel v. Helvering*, 312 U.S. 552, 556 . . . (1941), the Court explained that this is "essential in order that parties may have the opportunity to offer all the evidence they believe relevant to the issues . . . [and] in order that litigants may not be surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence."

See *Duignan v. United States*, 274 U.S. 195, 200 (1927); *Taylor v. Freeland & Kronz*, ___ U.S. ___, 112 S. Ct. 1644, 1649 (1992).

At the trial level, NUFIC had ample opportunity to make the arguments advanced only on appeal, and to offer evidence, if any, in support thereof. It did not. To the detriment of the debtor's creditors, the Trustee and SIPC,

NUFIC should not be indulged in its assertion of bogus issues at this late juncture.

B. The Statutory Schemes Administered by the FDIC and SIPC Are Distinct.

Even assuming, *arguendo*, that no question of timeliness existed, NUFIC has not shown that the thrift and bank cases apply. Contrary to NUFIC's contention, and unlike the FDIC,[6] SIPC has no statutory authority to require issuance of a bond. Indeed, the bond in question was required under National Association of Securities Dealers ("NASD") and not SIPC rules. Moreover, SIPC did not consent, as a matter of law or fact, to the termination clause. Had the question been raised below, SIPC would have shown that, in fact, it actively opposed it.

i. The Powers of the FDIC Are Broader Than Those of SIPC.

To be sure, predecessor bills to SIPA would have patterned SIPC after the FDIC. See, *e.g.*, 115 Cong. Rec. 15165-15170 (June 9, 1969) (remarks of Sen. Muskie). The kind of organization contemplated under those proposals and its responsibilities were summarized as follows:

> This is the key to understanding the functions and philosophy of the Federal guaranty system. Because a weakening of public confidence in the safety of deposits cannot be allowed to develop at the outset, FDIC and FSLIC consider the prevention of failures the best safeguard. In this regard, these bodies are neither more nor less than regulatory agencies .... They accomplish their regulatory objectives by examining member institutions to ensure financial soundness and by administering a constantly evolving network of laws, rules and regulations that prescribe,

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[6] In pertinent part, under 12 U.S.C. section 1828(e), the FDIC "may require any insured depository institution to provide protection and indemnity against burglary, defalcation, and other similar insurable losses." See *supra*, n.5.

> often in minutest detail, the standards under which members will conduct their day-to-day operations.

Hearings on S. 2348, S. 3988, and S. 3989 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. ("Hearings on S. 2348") 212 (April 17, 1970) (testimony of Mr. Gardiner, Chairman, Leg. Comm., Assoc. of Stock Exchange Firms). However, as illustrated below, this approach received opposition:

> Finally, let me comment briefly on the FDIC, which has been proposed as a model for our industry. In the words of . . . the retiring head of the FDIC, that body "should not be compared to the insurance functions of a private insurer." It serves, instead, principally as a regulatory agency brought into being in 1933 to minimize bank failures. . . .
>
> Models chosen from one field of activity rarely fit exactly the needs of another field. I do not think the pattern of the FDIC fits the securities industry very well.

Hearings on S. 2348 at 29 (April 16, 1970) (statement of Mr. Regan, President, Merrill, Lynch, Pierce, Fenner & Smith). Ultimately, the FDIC approach was rejected. *Cf.*, *SEC v. Morgan, Kennedy & Co.*, 533 F.2d 1314, 1318 (2d Cir.), *cert. den.*, 426 U.S. 936 (1976) ("SIPA and [the Federal Deposit Insurance Act ("FDIA")] are independent statutory schemes, enacted to serve the unique needs of the banking and securities industries, respectively. The Congress recognized this when it rejected several early versions of the SIPA bill which were patterned on FDIA. . . .").

The statute that finally emerged "neither created a new regulatory organization nor an additional layer of regulatory authority." *SIPC and Customer Protection* (2d ed. April 1986) at 2.[7] The role that SIPC would have is aptly

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[7] NUFIC asserts that even SIPC has analogized SIPC to the FDIC. Cert. Pet. at 9-10. In support of that assertion, it relies upon language

described as follows:

> Well, SIPC is a new federally chartered corporation, but essentially would be a vehicle to collect funds and to pay out funds when a broker-dealer is in financial difficulties. All of the regulatory power that is in the self-regulatory authorities would continue.

Hearings on S. 2348 at 231 (June 18, 1970) (statement of Mr. DeNunzio, Vice Pres. of the Bd. of Governors, N.Y. Stock Exchange). SIPC was to function within the established framework of broker-dealer self-regulation. H. R. Rep. No. 1613, 91st Cong., 2d Sess. 11-12 (1970) ("H. R. Rep. No. 1613"). That framework is considered below.

ii. The Relationship of SIPC to the SEC and NASD

SIPA is only one aspect of an extensive network of laws that apply to securities broker-dealers. Within that structure, SIPC's role and jurisdiction are narrow and intensely specialized—relating only to the liquidation of its members under SIPA. SIPC has no regulatory authority. That responsibility is exercised, in the first instance, by the SEC, and in the second, by the self-regulatory organizations or "SROs."[8] The following excerpt offers some insight into the regulatory process:

> The federal securities laws, primarily through the [1934 Act], provide a comprehensive scheme of regulation over "brokers" and "dealers" in corporate and other business entity securities. This regulation includes registration with the [SEC], compliance with the SEC bookkeeping and reporting rules, as well as

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in the *Customer Protection* publication to the effect that a draft bill of SIPA would have created an organization with a role in the securities industry comparable to that of the FDIC and similar organizations. However, the quotation, which is only partial, is misleading. Ensuing language makes clear that the proposal was rejected inasmuch as the existing self-regulatory structure was retained, and no new regulatory organization was created. *SIPC and Customer Protection*, *supra*, at 1-2.

[8] SROs include, among others, national securities exchanges and registered securities associations such as the NASD. 15 U.S.C. §78c(a)(26).

> with its financial responsibility requirements, and adherence to a complex pattern of specialized antifraud standards. The major part of this regulatory system is administered directly by the SEC, which maintains a continuing surveillance over broker-dealer activities. * * * The [1934 Act] supplements direct SEC regulation with a statutory mandate for industry self-regulation by the national securities exchanges and securities associations registered with the SEC. The registered securities exchanges include the New York, American, and various regional exchanges, but only one securities association, the [NASD] is registered with the SEC.

N. Wolfson, *Regulation of Brokers, Dealers and Securities Markets*, ¶1.01 at p. 1-2 (1977).

With certain narrow exceptions, every securities broker or dealer must be registered with the SEC. By virtue of that registration under section 15(b) of the 1934 Act, 15 U.S.C. §78o(b), brokers or dealers automatically are members of SIPC. SIPA §78ccc(a)(2)(A). To the extent that they do not effect transactions only on a national securities exchange, they also must be registered with the NASD.[9] 15 U.S.C. §78o(b)(8). Thus, in general, every SIPC member is not only registered with the SEC, but is, in addition, a member of an SRO.

The SEC and SROs play an important role in furthering the objectives of SIPA. A principal goal under SIPA is to reinforce confidence in the marketplace, by providing for the protection of customers in the event of a stockbroker

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[9] Under the supervision of the SEC, the NASD is authorized under 15 U.S.C. section 78o-3, "to promulgate rules designed to prevent fraudulent and manipulative practices; to promote equitable principles of trade; to safeguard against unreasonable profits and charges; and generally to protect investors and the public interest. . . ." *United States v. NASD*, 422 U.S. 694, 702 n.6 (1975). *See First Jersey Securities, Inc. v. Bergen*, 605 F.2d 690, 692-693 (3d Cir. 1979), *cert. den.*, 444 U.S. 1074 (1980); *Austin Mun. Securities v. NASD*, 757 F.2d 676, 679-681 (5th Cir. 1985).

failure. Of equal if not greater importance is its goal of eliminating the risks that might lead to such a failure by "achiev[ing] a general upgrading of financial responsibility requirements." S. Rep. No. 1218, 91st Cong., 2d Sess. 4 (1970). See *In re Investors Center, Inc.*, 129 B.R. 339, 341 (Bankr. E.D.N.Y. 1991).

Under SIPA, Congress sought to accomplish the latter objective by requiring the SEC to adopt financial responsibility rules, and by giving the SEC and SROs the power to monitor compliance with them. Thus, section 7(d) of SIPA, 15 U.S.C. §78o(c)(3) (1970), amended the 1934 Act to confer on the Commission "rulemaking power with respect to financial responsibility and related practices of brokers and dealers." H. R. Rep. No. 1613 at 22-23.[10] *See* 116 Cong. Rec. 40868 (Dec. 10, 1970) (remarks of Mr. Muskie). And, it imposed on the SEC and SROs the duty to examine or inspect members for compliance with those rules. SIPA §78iii(c). The oversight and investigatory powers of the SEC and SROs enable them to carry out their responsibility with respect to the second objective of SIPA. Thus, if they are aware of facts leading them to believe that a stockbroker is in or approaching financial difficulty, they must notify SIPC. §78eee(a)(1). Based upon that information, SIPC determines whether commencement of a proceeding is warranted. §78eee(a)(3).

iii. The Bond Was Required Pursuant to NASD Rule, and Not SIPA.

GSC was required to obtain the fidelity bond in question pursuant to Article III, section 32 of the NASD Rules of Fair Practice, and App. C thereto. See Cert. Pet. at 43a-

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[10] SIPA section 7(d), contained in the Statutory Appendix hereto (SA-1), amended section 15(c)(3) of the 1934 Act, 15 U.S.C. §78o(c)(3) (1970). In 1975, section 15(c)(3) was further amended to require the SEC to adopt minimum financial responsibility requirements no later than September 1, 1975. Pub. L. No. 94-29, 89 Stat. 126 (1975).

For purposes of SIPA, "financial responsibility rules" include various SEC and SRO rules relating to the protection of funds or securities. 17 C.F.R. §240.3a40-1 (1992).

46a. Since SIPC has no regulatory authority, NUFIC's conclusion that "the rules of the [SROs] are imposed, by SIPA, directly on all SIPC members just as surely as if those rules had been promulgated by SIPC itself" is, at the very least, puzzling. Cert. Pet. at 7. By attributing the rules of the NASD to SIPC and thereby concluding that *SIPC* required issuance of the bond, Cert. Pet. at 10, NUFIC plainly ignores the fact that SIPC was not patterned after the FDIC. Although it works closely with the SEC and the self-regulators, it itself has no comparable authority. Thus, it does not set financial responsibility requirements for its members; it has no power to investigate whether such requirements are being met; and it has no authority to compel its members to meet such requirements.

Nevertheless, relying upon an interpretation of SIPA section 78iii(c) that defies not only the plain meaning and legislative history of the provision, but logic, NUFIC asserts that the section supports its conclusion that the bond was required under SIPA. Cert. Pet. at 7. In part, the section provides:

> The [SRO] of which a member of SIPC is a member or in which it is a participant shall inspect or examine such member for compliance with applicable financial responsibility rules. . . .

The section also specifies the SEC as the examining authority under certain circumstances. *Id.* Obviously, section 78iii(c) does not impose the rules of the NASD on SIPC members. Those rules already apply to brokers or dealers that are members of the NASD under other authority. See NASD Rules of Fair Practice, Art. I, §5(a) ("these Rules of Fair Practice shall apply to all members. . . ."), and Art. II, §1(c) ("member" includes, among others, any corporation admitted to membership in the NASD), *reprinted in* NASD Manual-Rules of Fair Practice (CCH) ¶¶2005 and 2101, at pp. 2011 and 2012. Instead, section 78iii(c) simply designates the SEC and SROs as examining authorities to enable them to carry out their responsibility of notifying

SIPC when a broker or dealer is in financial trouble. SIPA §78eee(a)(1). See H. R. Rep. No. 1613 at 23. NUFIC's attempt to attribute a more expansive authority to SIPC simply has no basis in the law.

iv. SIPC Never Approved of the Termination Clause.

The attempt also fails as a matter of fact. In a last minute effort not made before any lower court, see *supra*, NUFIC asserts that SIPC "concealed" from the Eleventh Circuit its knowledge that the NASD adopted the bond requirement "at SIPC's prompting and in full consultation with SIPC pursuant to §78iii(e)." Cert. Pet. at 12. In fact, SIPC practiced no deceit before the Eleventh Circuit. Instead, it is petitioner's conduct before this Court that is in question.

In the first place, SIPA section 78iii(e) is not at issue. That provision requires SIPC to "consult and cooperate" with the SROs toward the development of early warning and surveillance procedures that will enable the SRO to detect whether a firm is in financial trouble. See H. R. Rep. No. 1613 at 23. Plainly, a bond requirement is not encompassed by the section. Second, SIPC's position and conduct with respect to stockbroker fidelity bonds—from the adoption of the requirement by the NASD through SIPC's support for the Trustee's position in this case—have been unwaivering. At all times, where the claim is valid, SIPC has supported recovery under the bond, whether or not the firm is in SIPA liquidation.

Because the availability of a fidelity bond may have a direct impact on the failure of a firm, SIPC did express its concern to the SEC and the NASD that many brokers did not carry bonds. First Annual Report of SIPC at 32 (1971). Cert. Pet. at 10. After all, a bond may enable a broker to avoid liquidation. And, even if the broker fails, it offers a means of recovery for customers whose claims exceed the monetary limits of SIPA protection, and for general creditors because their claims cannot be satisfied from SIPC funds. See SIPA §78fff-3(a). However, even

assuming *arguendo* that the question were relevant, SIPC never approved of the GSC bond. Cert. Pet. at 12.

NUFIC does not allege that SIPC actually negotiated the standard bond.[11] It merely contends that SIPC "had full knowledge that the *SROs and the Surety Association of America* ["SAA"] worked together to develop the required bond" (emphasis added). *Id.* at 11. In any event, the standard bond, as it existed in the early 1970s when SIPC noted its approval of the adoption by the NASD of a proposed bonding requirement, would not have been objectionable to SIPC because it permitted a trustee to make recovery under it. Yet, NUFIC attempts to suggest otherwise—one, by omitting key language from its citation of a SIPC annual report; and two, by failing to bring to this Court's attention the fact that the 1970s bond allowed recovery.

In citing a passage from SIPC's 1972 Annual Report, petitioner coyly omits from it, a key sentence showing that SIPC perceived the bond as providing protection that was in addition to, and not in lieu of, the SIPA protection. The omitted sentence (in italics) is as follows:

> [W]e are pleased to note that the membership of the NASD recently approved a proposal which authorizes its Board of Governors to require that NASD members, who are members of SIPC . . . obtain such bonds. *The proposal would supplement the protections provided by SIPC by covering losses sustained by forgery, misplacement of securities and fraudulent trading . . . .*

SIPC Second Annual Report (1972), at 37. *Cf.*, Cert. Pet. at 11.

SIPA does not protect losses based on forgery, misplacement of securities, or fraud. *SEC v. S.J. Salmon & Co.*, 375 F.Supp. 867, 870-71 (S.D.N.Y. 1974); *In re Bell & Beckwith*, 124 B.R. 35, 36 (Bankr. N.D. Ohio 1990); *In*

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[11] When adopted, the NASD rule required that the bond be "in a form substantially similar to the standard form of Brokers Blanket Bond promulgated by the SAA." Cert. Pet. at 44a.

re MV Securities, Inc., 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985). It is impossible that the fidelity bond could "supplement" the SIPC protection by insuring such losses unless recovery could be had even after the broker was in liquidation. It is apparent from the omitted language that SIPC did not regard the bond as an *alternative* to SIPA protection, as NUFIC implies, but as an addition to it. Of necessity, a trustee could assert a claim.

NUFIC also conveniently neglects to apprise the Court that while the standard fidelity bond which was in effect from 1970 until 1987, provided for termination upon appointment of a liquidator, it also authorized the liquidator to purchase an additional period within which to discover any loss, and thus, to assert a claim. In part, the bond specified:

> RIGHTS AFTER TERMINATION OR CANCELATION
>
> Section 12. At any time prior to the termination or cancelation of this bond as an entirety, whether by the Insured or the Underwriter, *the Insured may give to the Underwriter notice that it desires under this bond an additional period of twelve months within which to discover loss* sustained by the Insured prior to the effective date of such termination or cancelation and shall pay an additional premium therefor. *If this bond is terminated or canceled as an entirety by reason of the taking over of the insured by a . . ., liquidator, such . . . liquidator . . . shall have the rights of the Insured . . .* provided that such rights are exercised by notice to the Underwriter within thirty days after such insured is taken over by such . . . liquidator . . . and provided, further, that such Insured has not previously exercised such rights. *Upon receipt of such notice* from the insured or *from such . . . liquidator . . ., the Underwriter shall give its written consent thereto. . . .* [emphasis added].

L. Barbagallo, App. I to *The Financial Institution Bond, Standard Form 14—Revision of the Stockbrokers Blanket Bond, Standard Form 14—Oct. 1987* (ABA Tort and In-

surance Practice Section ("TIPS") Annual Meeting 1988) ("Barbagallo, *Standard Form 14*"). See *id.* at 1 (referring in 1988 to the "revision of the Stockbrokers Blanket Bond, Standard Form 14, last revised in September 1970"). See also J. Knoll, *Special Provisions of Brokers, Insurance Companies and [S & L] Blanket Bonds, reprinted in Financial Institution Bonds* (ABA TIPS 1989) at 238 (referring to the "Financial Institution Bond, Standard Form No. 14 (October, 1987 revision)" which "replaced the previous Stockbrokers Blanket Bond (1970 revision) of the same number.")[12]

Thus, at the time that SIPC issued its 1971 and 1972 annual reports, the bond clearly allowed a trustee to recover under it. NUFIC's suggestion that the reports show that SIPC approved of the GSC termination clause and concealed that information from the Eleventh Circuit is as false as it is reprehensible. Moreover, although the standard bond was revised in 1987 to include the termination clause as reflected in the GSC bond, Barbagallo, *Standard Form 14* at App. II, it is not clear whether the revision occurred before or after the bond was issued to the debtor that year. NUFIC offers no factual support for its assertion that SIPC approved the standard bond after its revision in 1987. And indeed it cannot, since none exists.

The foregoing discussion reveals why review is inappropriate. NUFIC has advanced *no* valid authority for its contention that the thrift and bank cases should be deemed to apply. Plainly, the statutory schemes creating the FDIC and SIPC have vested them with different degrees of power. SIPC had no authority, as a matter of law, to require issuance of the bond. And even assuming, *ar-*

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[12] Very recently, SIPC staff has learned that the SAA approved a rider, effective December 1980, for use with the standard bond. In pertinent part, the rider terminated the bond upon appointment of a liquidator and provided for no purchase of an additional discovery period. However, the standard bond itself was not modified until 1987. And, in issuing its reports in the very early 1970s, SIPC could not have known of the rider that would be approved years later.

guendo, that the question were relevant[13] and had been timely raised, it never approved of the termination clause as a matter of fact. In that regard, whether the meager evidence which NUFIC now relies upon to attempt to establish SIPC's alleged approval is adequate presents no question worthy of review. *Cf.*, *United States v. Johnston*, 268 U.S. 220, 227 (1925) ("[we do not grant a certiorari to review evidence and discuss specific facts."). The thrift and bank cases are based on a different statutory scheme, and hence, are inapplicable and not in conflict with the decision of the Eleventh Circuit.

v. NUFIC Is Held to Know the Law.

Finally, NUFIC asserts that it is inequitable for the Trustee and SIPC selectively to invalidate provisions of the bond. Cert. Pet. at 14, 19. However, the only potential unfairness is to creditors of the firm in SIPA liquidation. NUFIC conceded in the Court of Appeals that section 541(c)(1)(B) would invalidate the clause in an ordinary bankruptcy liquidation of a stockbroker. See NUFIC Appellate Brief at 16. There is no reason for creditors to fare less well simply because the broker is in SIPA liquidation. Even if the termination clause is not enforced, there is no unfairness to NUFIC. Both section 541(c)(1)(B) and SIPA section 78fff(b) existed at the time that NUFIC contracted with GSC. Hence, NUFIC measured the risk of issuing the bond, and determined that the benefit to it outweighed the risk.

Section 541(c)(1)(B) was enacted as part of the Bankruptcy Reform Act of 1978. Pub. L. No. 95-598, 92 Stat.

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[13] The question is irrelevant because SIPC had no statutory authority either to require a bond or to approve its terms. Even assuming, *arguendo*, that SIPC had approved it, that approval would be meaningless. Congress clearly has expressed its intent in 11 U.S.C. section 541(c)(1)(B), made applicable to a SIPA proceeding, that such provisions are invalid. SIPC could not modify the law. *Cf.*, *Federal Crop Insurance Corp. v. Merrill*, 332 U.S. 380, 384 (1947) ("anyone entering into an arrangement with the Government takes the risk of having accurately ascertained that he who purports to act for the Government stays within the bounds of his authority.")

2594 (1978). Although no comparable provision existed under the Bankruptcy Act, see 4 *Collier on Bankruptcy*, ¶541.22 at p. 541-113 (15th ed. 1992), section 541(c)(1)(B) had been in effect for nearly ten years, by the time NUFIC issued the bond to GSC in 1987. In undertaking to do business with GSC, NUFIC knew that its transactions would be subject to existing laws. As stated in *In re Prima*, 88 F.2d 785, 788 (7th Cir. 1937):

> All parties to a contract are, of necessity, aware of the existence of, and subject to, the power of Congress to legislate on the subject of bankruptcies. They were and are chargeable with knowledge that their rights and remedies, in case the debtor becomes insolvent and is adjudicated a bankrupt, are affected by existing bankruptcy laws . . . .

See Wright v. Union Central Ins. Co., 304 U.S. 502, 516 (1938); *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 435 (1934); *In re Golden*, 16 B.R. 580, 583 (Bankr. S. D. Fla. 1981). *See also Federal Crop Ins. Corp. v. Merrill*, *supra*, 332 U.S. at 384 ("everyone is charged with knowledge of the United States Statutes at Large"). There is no unfairness to NUFIC and no reason to grant review.

II. THE DECISION THAT SUBSTANTIVE PROVISIONS OF TITLE 11 APPLY IS NOT IN CONFLICT WITH THE DECISION OF ANY OTHER CIRCUIT.

Review also is inappropriate because the holding that section 541(c)(1)(B) applies, does not conflict with decisions of the Second and Third Circuit. Cert. Pet. at 22, 24-26. The two cases relied upon by NUFIC are distinguishable. Neither one of them addressed the substantive versus procedural distinction raised in this case, and both construed SIPA section 78fff(c)(1), the 1970 predecessor of section 78fff(b). Since that time, the meaning of the section has been clarified. The language of the current section, and its legislative history, make clear that whether a Bankruptcy Code provision applies to a SIPA proceeding does not depend on whether it is substantive or procedural, as

NUFIC maintains, but solely on whether it is consistent with SIPA. For the reasons discussed below, there is no conflict.

1. The Plain Meaning of Section 78fff(b)

There are two operative requirements under the relevant portion of section 78fff(b). The SIPA liquidation, to the extent consistent with SIPA, must be conducted 1) "in accordance with" and 2) "as though it were being conducted under chapters 1, 3, and 5, and subchapters I and II of chapter 7 of title 11." The Title 11 provisions referred to in section 78fff(b) are *all* of the straight bankruptcy liquidation provisions of the Code, except for the stockbroker and commodity broker provisions. If each clause of section 78fff(b) is to be given effect, as it must, *Petition of Public Nat. Bank of New York*, 278 U.S. 101, 104 (1928) (statute should be construed so that "no clause, sentence, or word shall be superfluous, void, or insignificant"), then in order for the liquidation to be conducted "in accordance with" Title 11, section 541(c)(1)(B), contained as it is in chapter 5 of the Code, must be held to apply. Moreover, in order for the SIPA liquidation to be conducted "as though it were being conducted" under the straight bankruptcy provisions of Title 11, the procedures that apply in ordinary bankruptcy must equally be deemed to apply to SIPA liquidations. The only limitation on whether a Title 11 provision applies is not one of procedure versus substance. Instead, as provided in section 78fff(b), it is that the provisions of the Code, procedural and substantive alike, must be consistent with SIPA. A provision is not consistent with SIPA if it "conflicts with an explicit provision" of SIPA or if its application "would substantially impede the fair and effective operation of SIPA without providing significant countervailing benefits." *SIPC v. Charisma Sec. Corp.*, 506 F.2d 1191, 1195 (2d Cir. 1974). See also *SIPC v. Securities Northwest, Inc.*, 573 F.2d 622, 625 (9th Cir. 1978). Section 541(c)(1)(B) does not conflict with any explicit provision of SIPA. Rather, it is the failure to apply it to the case at hand which "would sub-

stantially impede the fair and effective operation of SIPA." *SIPC v. Charisma Sec. Corp., supra,* 506 F.2d at 1195.

2. NUFIC's Interpretation of Section 78fff(b) Limits the Trustee's Powers In a Manner Inconsistent With the Statutory Scheme and Detrimental to Creditors.

A SIPA liquidation contemplates not only satisfaction of customer claims, but the liquidation of the debtor's business, and the satisfaction of claims filed by general creditors. See SIPA §§78fff(a)(4) and 78fff-2(a)(3).[14] To accomplish those ends, the SIPA trustee not only has the unique powers that enable him to perform the special functions of a SIPA liquidation, but also the powers of an ordinary bankruptcy trustee. §78fff-1(a) (SA-2). *See SIPC v. Christian-Paine & Co.*, 755 F.2d 359, 361 (3d Cir. 1985); *Executive Securities Corp. v. Doe*, 702 F.2d 406, 407 (2d Cir. 1983), *cert. den.*, 464 U.S. 818 (1983); *SEC v. Albert & Maguire Sec. Co.*, 560 F.2d 569, 574 (3d Cir. 1977). *See also* 3 *Collier on Bankruptcy*, ¶60.85 at p. 1246 (14th ed. 1977). Practical reasons support the trustee's expansive powers. As observed in *Gold v. Hyman*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,043 at pp. 97,657–97,658 (S.D.N.Y. 1975):

> A SIPA trustee was undoubtedly intended by Congress to completely liquidate a brokerage business which had failed—including processing all creditor claims as well as customer claims. Indeed, a SIPA trustee has even more powers in some circumstances than a trustee in bankruptcy. For Congress to have provided otherwise would have been unwise and inefficient. A SIPA trustee knows the situation well by

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[14] The fact that the SIPA trustee completes the entire liquidation of a debtor finds support in 11 U.S.C. section 742. That section authorizes SIPC to seek to have a stockbroker already in bankruptcy, placed in SIPA liquidation, notwithstanding the automatic stay provisions of section 362 of the Code. The filing of the SIPC application operates as a stay of any Title 11 proceeding, and "[i]f SIPC completes the liquidation of the debtor, then the court shall dismiss the case." §742.

> the time customer claims are processed and is obviously the proper person to complete liquidation.

The powers of a SIPA trustee are co-extensive with his duties. In addition to his duties to customers of a debtor, a SIPA trustee is "subject to the same duties as a trustee in a case under chapter 7 of title 11," to the extent consistent with SIPA. §78fff-1(b). As stated in *Matter of Lewellyn*, 26 B.R. 246, 253-54 (Bankr. S.D. Iowa 1982):

> The [SIPA] trustee has certain duties which are separate from his duties under the Bankruptcy Code. These relate to a stockbroker's customers. . . . At the same time, the trustee is a trustee bound by the Bankruptcy Code to perform the duties of a trustee under the provisions of the Bankruptcy Code. . . . The [SIPA] proceeding looks not only to the claims of customers but also the claims of general creditors . . . . This is to say that the trustee's impartiality applies to all creditors and his responsibility is to the entire bankruptcy estate and not to just stockbroker-debtor customers. [Citations omitted].

One of the duties of a chapter 7 trustee is to "collect and reduce to money the property of the estate." 11 U.S.C. §704(1). A consequence of that duty is that in order to maximize the estate for the benefit of creditors, the bankruptcy trustee, as appropriate, must bring suit. As stated in another SIPA case:

> In the absence of liquidation proceedings, any cause of action for damages which accrued to the partnership . . . could have been prosecuted by the partnership in its own name. . . . However, the partnership has been placed into [SIPA] liquidation. When that was done the provisions of 11 U.S.C. §541 became applicable. *See*, 15 U.S.C. §78fff(b). . . .
>
> It is well settled that causes of action which belong to the debtor at the time of the commencement of a case become part of the estate. . . . The Trustee as representative of the estate,. . .is the only entity en-

> titled to pursue such causes of action. [Citations omitted].

In re Bell & Beckwith, 50 B.R. 422, 433 (Bankr. N. D. Ohio 1985). See also *SIPC v. Poirier*, 653 F.Supp. 63, 65-66 (D. Ore. 1986).

It is implausible that Congress would, on the one hand, confer on the SIPA trustee the obligations of a Title 11 trustee, but on the other hand, limit the trustee in his ability to perform those obligations solely because the debtor is in liquidation under SIPA. Were this case initiated under Title 11, a trustee would be able to rely on the anti-termination provisions of the Code. *See, e.g., In re Manning*, 831 F.2d 205, 211 (10th Cir. 1987). If GSC were a brokerage firm in liquidation under subchapter III of chapter 7 of the Code, the Trustee plainly could rely on such provisions. 11 U.S.C. §103(a).[15] Congress intended no different outcome merely because the liquidation is under SIPA. In that regard, nothing in SIPA or the Code supports the ultimate result of NUFIC's position, namely, that creditors in a SIPA liquidation are to be more disadvantaged than their counterparts in ordinary bankruptcy.

It also bears mention that NUFIC's interpretation of section 78fff(b) would undermine the statutory scheme by creating gaps in the administration of the liquidation that would make it impossible to be completed. For example,

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[15] Subchapter III governs the liquidation of broker-dealers that are not in SIPA liquidation, for example, because the broker or dealer, although otherwise bankrupt, is nevertheless able to meet its customer obligations. NUFIC asserts that a SIPA liquidation is so different from one under the Code that the stockbroker liquidation provisions of Title 11 do not even apply. Cert. Pet. at 24. *See* SIPA §78fff(b) (not incorporating subchapter III). Obviously, they would not apply since the aspects of a liquidation unique to broker-dealers, are instead addressed by SIPA. This fully comports with the legislative intent that the provisions of the Code apply to the extent consistent with SIPA. At any rate, NUFIC overlooks the fact that, except for the availability of SIPC's funds, the stockbroker liquidation provisions of Title 11 are nearly identical to those of SIPA.

terms defined in the Code could not be given their statutory meanings; executory contracts could not be deemed rejected if not acted upon within 60 days after the order for relief, 11 U.S.C. §365(d)(1); the trustee's avoidance powers would be substantially curtailed; the trustee would have no claim against the estates of general partners to the extent debts could not be satisfied from a debtor-partnership's assets, §723(c); no determination could be made as to the secured status of any claim, §506(a); or the extent to which any such lien were void, §506(d). Moreover, determining whether a provision of the Code was exclusively "procedural" and not substantive, would complicate further the administration of the liquidation. In short, NUFIC's interpretation creates a liquidation process that differs markedly from the one established by Congress. The fact that such a liquidation process results cuts against the notion that only procedural provisions apply.[16]

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[16] NUFIC contends that because specific substantive sections of the Code already are referred to in various provisions of SIPA, Congress could not have intended non-specifically designated ones to apply. Cert. Pet. at 28. Yet, under that reasoning, procedural provisions would not apply either, and section 78fff(b) would be meaningless, since they too are referred to throughout SIPA. See, *e.g.*, section 78eee(b)(3) (trustee qualifies by filing bond in manner prescribed by section 322); section 78eee(b)(5)(B) (requiring fee applications to conform in form and content with provisions of Title 11); and section 78fff(e) (requiring general estate to be distributed in order provided in section 726 of the Code).

NUFIC also misinterprets SIPC's support of an amendment to section 362(a) of the Code to apply, by its own terms, to SIPA cases. Cert. Pet. at 28. SIPC supported the amendment not because section 362(a) would not have applied under section 78fff(b), but because it would have applied too late. Under section 78fff(b), the provisions of Title 11 apply to a SIPA "liquidation proceeding". But the liquidation proceeding does not begin until a trustee is appointed. SIPA §78*lll*(10). Thus, section 362(a) which, in ordinary bankruptcy, imposes certain stays upon the mere filing of the bankruptcy petition, would not have applied to a SIPA case at the most critical time, *i.e.*, when SIPC files the application for a protective decree.

3. Nothing in the Legislative History of Section 78fff(b) Supports the Conclusion that Only Procedural Provisions Apply.

Even assuming, *arguendo*, that the meaning of section 78fff(b) is not clear, and that it therefore is necessary to examine the legislative history, *Blum v. Stenson*, 465 U.S. 886, 896 (1984), NUFIC's position is still untenable.

The predecessor of section 78fff(b) under the 1970 original version of SIPA was section 78fff(c)(1) (SA-3). While providing that no reorganization plan was to be formulated, the section incorporated into the SIPA proceeding, to the extent consistent with SIPA, the reorganization provisions of Chapter X, as well as the liquidation provisions of Chapters I through VII, of the Bankruptcy Act. The difficulties posed by the attempted reconciliation of provisions with diverse goals, that is, reorganization versus liquidation, among other reasons, led to a revision of section 78fff(c)(1) in 1978.

The process of examining SIPA, with a view toward amending it, had begun a few years earlier. In 1974, SIPC created a Special Task Force to study possible amendments to SIPA—including section 78fff(c)(1). A report was prepared by the Task Force and transmitted to Congress in connection with its consideration of amendments to SIPA that began in 1975, and resumed in 1977. H. R. Rep. No. 746, 95th Cong., 1st Sess. at 35 (1977) ("H. R. Rep. No. 746"). It is plain from a review of the report that the Task Force understood full well that both procedural and substantive provisions of the Bankruptcy Act applied to SIPA proceedings. Thus, with respect to section 78fff(c)(1), the Task Force recommended that the wholesale incorporation of the Bankruptcy Act into SIPA be eliminated, and that the "points of *substantive* bankruptcy law and procedure" either be set forth in SIPA or incorporated by reference to specific provisions of the Act. Its recommendation was based on its perception that the incorporation of both reorganization and liquidation provisions had caused confusion among SIPA trustees and their

counsel as to which applied. The Task Force also noted that a new "Federal Bankruptcy Act" was under consideration by Congress which, if adopted, might "substantially change bankruptcy procedure and administration, as well as certain *substantive* rights." Any changes in the Bankruptcy Act, "not inconsistent with SIPA," would apply automatically under SIPA. *Hearings on H.R. 8331 Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 95th Cong., 1st Sess. at 137-138 (Aug. 1, 1977) (Report to the SIPC Board of Directors of the Special Task Force to Consider Possible Amendments to SIPA of 1970) (emphasis added).

As amended in 1978, section 78fff(c)(1) became section 78fff(b). The Task Force recommendation was followed, to the extent that section 78fff(b) "eliminated the wholesale incorporation of chapter X of the Bankruptcy Act." S. Rep. No. 763, 95th Cong., 2d Sess. at 11 (1978), *reprinted in* 1978 U. S. CODE CONG. & ADM. NEWS 774. SIPA proceedings were made "subject to those Bankruptcy Act provisions relating to ordinary bankruptcy." *Id.* Thus, section 78fff(b) provided that to the extent consistent with SIPA, the liquidation proceeding was to be conducted "in accordance with, and as though it were being conducted under, the Bankruptcy Act. . . ." Pub. L. No. 95-283, 92 Stat. 259 (1978).

Additional changes were made to section 78fff(b) that same year, when the Bankruptcy Reform Act of 1978 was adopted. To conform it technically to the new law, section 78fff(b) was amended to its current form, incorporating specifically the liquidation provisions under "chapters 1, 3, 5 and subchapters I and II of chapter 7 of title 11". Pub. L. No. 95-598, 92 Stat. 2675 (1978).

Nothing in the legislative history of section 78fff(b) supports the interpretation advanced by NUFIC. The sole limitation on the applicability of Title 11 provisions is, as discussed above, consistency with SIPA. See *SEC v. Wick*, 360 F.Supp. 312, 315 (N.D. Ill. 1973) (In view of clear

legislative intent, effect of SIPA on Bankruptcy Act is limited. Provisions of SIPA supersede those of Bankruptcy Act only to the extent they are inconsistent).

4. The Cases Cited by NUFIC Present No Conflict.

The cases relied upon by NUFIC compel no different conclusion. *Redington v. Touche Ross & Co.*, 612 F.2d 68 (2d Cir. 1979), addressed the issue of federal court jurisdiction of an action by a SIPA trustee against an accounting firm for damages. Its consideration of former SIPA section 78fff(c)(1) was limited to the meaning of the term in the context of a "SIPA court's powers with regard to jurisdiction and procedure." 612 F.2d at 71. It is noteworthy that a few years earlier, the Second Circuit confronted the question of whether section 241 of the Bankruptcy Act, 11 U.S.C. §641 (repealed 1979), applied to a SIPA case. *SIPC v. Charisma Sec. Corp.*, 506 F.2d 1191 (2d Cir. 1974). That provision, ostensibly a substantive one, allowed a judge to award reasonable compensation to a trustee and other officers. In determining that the provision applied, the court devised no substantive-procedural test, as NUFIC has. Cert. Pet. at 26. Instead, adhering to the language of section 78fff(c)(1), it considered only whether the provision was consistent with SIPA. 506 F.2d at 1195-1196.

Like the *Redington* case, *SEC v. Aberdeen*, 526 F.2d 603 (3d Cir. 1975), is distinguishable. In spite of some overly broad dictum in the opinion,[17] it is clear that section 243 of the Bankruptcy Act, 11 U.S.C. §643 (repealed 1979), was deemed inapplicable not because it was a substantive provision, but because in furthering a debtor's reorganization and not liquidation, it was inconsistent with SIPA. 526 F.2d at 606 (section 243 "serves to redress the balance of power between insiders and outsiders during a corporate reorganization.") As discussed above, in spite of its incor-

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[17] As noted *supra*, two years earlier, the same court referred to SIPA as an "engraftment of insurance provisions upon the preexisting section 60(e) bankruptcy provisions applicable to stockbrokers. . . ." *SEC v. Aberdeen Securities Co.*, *supra*, 480 F.2d at 1123.

poration of reorganization provisions of the Bankruptcy Act, section 78fff(c)(1) expressly prohibited a reorganization. Here too, NUFIC has presented no conflict.

At bottom, the construction of the particular contract entered into between NUFIC and GSC is significant only to the parties involved, and has no importance beyond its immediate confines. Thus, depending upon the final outcome of this matter, one party may adjust its position—a debtor, if feasible, perhaps by giving notice of a possible loss prior to being placed in liquidation, and the insurance company, perhaps by revising its premiums. At any rate, it is plain that the questions raised by NUFIC fall far short of the kinds that are appropriate for review by this Court. The statement in *Layne & Bowler Corp. v. Western Well Works*, 261 U.S. 387, 393 (1923), is particularly applicable:

> [I]t is very important that we be consistent in not granting the writ of certiorari except in cases involving principles the settlement of which is of importance to the public, as distinguished from that of the parties, and in cases where there is a real and embarrassing conflict of opinion and authority between the Circuit Courts of Appeals. The present case certainly comes under neither head.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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STATUTORY APPENDIX

Section 7(d) of the Securities Investor Protection Act, 15 U.S.C. §78o(c)(3) (1970):

(d) FINANCIAL RESPONSIBILITY.—Section 15(c)(3) of the Securities Exchange Act of 1934 is amended to read as follows:

"(3) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities, and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances, as determined by such rules and regulations."

Section 7(a) of the Securities Investor Protection Act, 15 U.S.C. §78fff-1(a) (1981):

> A trustee shall be vested with the same powers and title with respect to the debtor and property of the debtor, including the same rights to avoid preferences, as a trustee in a case under title 11.

Section 102(3) of the Bankruptcy Code, 11 U.S.C. §102(3) (1992):

> Rules of construction. In this title—
>
> * * *
>
> (3) "includes" and "including" are not limiting . . . .

Section 6(c)(1) of the Securities Investor Protection Act, 15 U.S.C. §78fff(c)(1) (1970):

> Except as inconsistent with the provisions of this chapter and except that in no event shall any plan of reorganization be formulated, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under, the provisions of chapter X and such of the provisions (other than section 96(e) of Title 11) of chapters I to VII, inclusive, of the Bankruptcy Act as section 502 of Title 11 would make applicable if an order of the court had been entered directing that bankruptcy be proceeded with pursuant to the provisions of such chapters I to VII, inclusive. . . .

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(5)

Supreme Court, U.S.
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No. 92-1046

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,

Petitioner,

vs.

JOHN R. CAMP, JR., TRUSTEE, and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

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OPPOSITION OF RESPONDENTS TO MOTION OF AMERICAN INSURANCE ASSOCIATION FOR PERMISSION TO FILE AMICUS CURIAE BRIEF

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-1046

NATIONAL UNION FIRE INSURANCE CO.
OF PITTSBURGH, PA.,

Petitioner,

VS.

JOHN R. CAMP, JR., TRUSTEE,
and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

OPPOSITION OF RESPONDENTS TO MOTION OF AMERICAN INSURANCE ASSOCIATION FOR PERMISSION TO FILE AMICUS CURIAE BRIEF

PRELIMINARY STATEMENT

Pursuant to Rule 37.4 of this Court, John R. Camp, Jr., the Trustee for the liquidation of Government Securities Corporation ("GSC"), and the Securities Investor Protection Corporation ("SIPC") submit this opposition to the motion of American Insurance Association ("the Association") for permission to file an *amicus curiae* brief in this case.[1] The motion should be denied because the Association, which is appearing in this case for the first time, raises no relevant matter. By and large, its brief merely

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[1] Motion to File Brief of *Amicus Curiae* and Brief of *Amicus Curiae* American Insurance Association In Support of Petition for Writ of Certiorari, dated January 7, 1993. References herein to the motion shall be to "*amicus* motion," and to the brief, "*amicus* brief".

restates the arguments made by National Union Fire Insurance Co. of Pittsburgh, PA. ("NUFIC"), in its petition for a writ of certiorari ("Cert. Pet.") herein. Furthermore, the constitutional issue which the Association asserts, in addition to having no merit, has never been raised by any party or considered by any court in this case. These reasons and others for denying the motion are discussed in more detail below.

ARGUMENT

This adversary proceeding arises within the liquidation proceeding under the Securities Investor Protection Act, 15 U.S.C. §78aaa *et seq.* ("SIPA"),[2] of GSC, formerly a securities broker-dealer. On May 12, 1987, on an application by SIPC, the United States District Court for the Southern District of Florida placed GSC in liquidation, appointed Mr. Camp as trustee, and removed the liquidation proceeding to the Bankruptcy Court for the same district. SIPA §78eee(b)(4). Petitioner NUFIC had issued a fidelity bond to GSC to protect it against damages resulting, among other things, from dishonest acts of its employees. Because such acts had taken place and damages had resulted, the Trustee filed a claim under the bond. NUFIC refused to honor the claim based on a provision of the bond which, in pertinent part, automatically terminated the bond upon the appointment of a liquidator ("the termination clause"). The Trustee filed the instant suit, seeking declaratory relief that under section 541(c)(1)(B) of the Bankruptcy Code, made applicable by SIPA section 78fff(b), the termination clause was invalid.[3]

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[2] "References herein to provisions of SIPA shall be to the United States Code, and for convenience, hereinafter shall omit "15 U.S.C."

[3] The Association incorrectly asserts that the termination clause was held invalid "[u]pon application of the SIPC." *Amicus* motion at 2. In fact, the instant suit was initiated by the Trustee and not SIPC. SIPC's participation in this matter has been pursuant to SIPA section 78eee(d).

The issue of whether section 541(c)(1)(B) applies has been addressed by three courts in this case—the most recent one being the Eleventh Circuit. Unanimously, these courts have concluded that section 541(c)(1)(B) applies. The decision of the Eleventh Circuit does not conflict with the decision of any other court. Nevertheless, relying upon cases involving thrifts and a bank in conservatorship or receivership (collectively, "the Bank cases"), in which termination clauses were upheld, NUFIC has attempted to create a conflict where none exists. See Cert. Pet. at 3-4.

1. The Amicus Brief Restates NUFIC's Argument As To The Bank Cases.

The Bank cases are not relevant because they involve different facts, different insured institutions, and most importantly, different statutes. Because notwithstanding its special customer protection features, a SIPA proceeding essentially is a bankruptcy liquidation,[4] provisions of Title 11, including section 541(c)(1)(B), are made applicable to SIPA cases under SIPA section 78fff(b). However, the same provisions cannot apply to banks and thrifts. As set forth in the legislative history of the Bankruptcy Reform Act of 1978, "[b]anking institutions . . . are excluded from liquidation under the bankruptcy laws because they are bodies for which alternate provision is made for their liq-

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Under that section, SIPC is "a party in interest as to all matters arising in a liquidation proceeding, with the right to be heard on all such matters."

[4] *SIPC v. Ambassador Church Finance/Development Group, Inc.*, 788 F.2d 1208, 1210 (6th Cir.), *cert. den. sub nom., Pine Street Baptist Church v. SIPC*, 479 U.S. 850 (1986) ("[e]ssentially, a liquidation under the SIPA is a bankruptcy proceeding"); *SEC v. Aberdeen Securities Co.*, 480 F.2d 1121, 1123 (3d Cir.), *cert. den. sub nom., Seligsohn v. SEC*, 414 U.S. 1111 (1973); *Exchange National Bank of Chicago v. Wyatt*, 517 F.2d 453, 456-459 (2d Cir. 1975).

uidation under various State or Federal regulatory laws." S. Rep. No. 989, 95th Cong., 2d Sess. at 31 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADM. NEWS 5817. See 11 U.S.C. §109(b)(2) (excluding banks and thrifts from liquidation under Title 11). Not only are stockbrokers and thrifts and banks liquidated under different laws, but as to the latter, Congress explicitly has enunciated a different policy with respect to the enforcement of contracts such as the one at hand. Thus, while it has expressed its intent under 11 U.S.C. section 541(c)(1)(B), that trustees recover under such bonds in stockbroker liquidations, it prohibits, under 12 U.S.C. section 1821(e)(12)(A), bank receivers or conservators from seeking a similar recovery. The Bank cases have been extensively addressed both in the certiorari petition and the joint opposition thereto. See Cert. Pet. at 3-21; and Respondents' Opposition thereto, dated January 15, 1993, at 6-21. By merely expounding upon NUFIC's arguments, the Association adds nothing to the analysis. Instead, it obscures the issue in this case, by seeking to have law that is irrelevant applied to its resolution.

2. The Issue As To Constitutionality Is Untimely Raised.

The Association's motion also should be denied because it interposes a constitutional question that was never raised by any party to this case or considered by any court below. Application of the general rule that federal appellate courts do not review issues not passed upon by the lower courts, is particularly appropriate here. *Duignan v. United States*, 274 U.S. 195, 200 (1927); *Hormel v. Helvering*, 312 U.S. 552, 556 (1941); *Singleton v. Wulff*, 428 U.S. 106, 120 (1976). There is no record upon which this Court may decide the issue, and at this late juncture it is patently unfair to the creditors of GSC, the Trustee, and SIPC, that they be surprised with a new issue, and that the litigation be prolonged by its resolution.

3. The Constitutional Issue Lacks Merit.

In any event, the Association's claim as to any purported lack of constitutionality is without merit. The contract between NUFIC and GSC was not impaired and there has been no unconstitutional taking of property. Section 541(c)(1)(B) of the Bankruptcy Code, made applicable by SIPA, had been in effect for nearly ten years when NUFIC issued the fidelity bond to GSC. Consequently, NUFIC knew that the termination clause would not be enforced if a liquidator was appointed for GSC.[5] See *In re Prima Co.*, 88 F.2d 785, 788 (7th Cir. 1937) ("parties to a contract are, of necessity, aware of the existence of, and subject to, the power of Congress to legislate on the subject of bankruptcies. They were and are chargeable with knowledge that their rights and remedies . . . are affected by existing bankruptcy laws. . . ."); *Federal Crop Ins. Corp. v. Merrill*, 332 U.S. 380, 384 (1947) ("everyone is charged with knowledge of the United States Statutes at Large"); *Wright v. Union Central Ins. Co.*, 304 U.S. 502, 516 (1938) ("existing laws read into contracts in order to fix obligations as between the parties"). In issuing the bond to GSC, NUFIC measured the risk and determined that the benefit to it outweighed that risk.

Moreover, under the facts of this case, there can be no genuine question as to the authority of Congress to legislate as it has under section 541(c)(1)(B) pursuant to its bankruptcy power. U. S. CONST., Art. I, §8, cl. 4. This conclusion is reinforced by the fact that the power to enact

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[5] At the time NUFIC issued the bond, the case law was clear that insurance contracts constituted property of the estate under section 541(a) of the Bankruptcy Code. *A. H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001-1002 (4th Cir.), *cert. den.*, 479 U.S. 876 (1986). Since that property was subject to other provisions of the Code, see, *e.g.*, *Matter of Gulf Tampa Drydock Co.*, 49 B.R. 154, 157 (Bankr. M.D. Fla. 1985), it would have come as no surprise to NUFIC that it would be subject to section 541(c)(1)(B) thereof as well.

SIPA, and thereby to make section 541(c)(1)(B) applicable to a SIPA case, is grounded not only in the bankruptcy clause, *id.*, but also in the commerce clause. U.S. CONST., Art. I, §8, cl. 3. *SEC v. Albert & Maguire Sec. Co.*, 378 F.Supp. 906, 911-912 (E.D. Pa. 1974); *Exchange National Bank of Chicago v. Wyatt*, 517 F.2d 453, 459 (2d Cir. 1975). *See Tepper v. Chichester*, 285 F.2d 309, 312-313 (9th Cir. 1960). Even assuming, *arguendo*, that such were the case here, "the power of Congress to modify substantial rights [under SIPA] rests upon a broad and substantial base." *SEC v. Albert & Maguire Sec. Co.*, *supra*, 378 F.Supp. at 912.

4. The Amicus Brief Reflects a Misunderstanding of SIPA.

Finally, the motion for permission to file an *amicus* brief herein should be denied because it reflects a fundamental misunderstanding of SIPA, and proceedings thereunder, and therefore, is potentially misleading. The Association contends that the decision of whether to issue a bond is based upon the insurer's assessment of the honesty of existing officers of the insured, and their ability to hire and supervise trustworthy employees. Because the take-over of the insured by a third party requires the insurer to underwrite the honesty of strangers, the bond is terminated. *Amicus* brief at 1-2. The Association overlooks the fact that because the objective of a SIPA proceeding is the liquidation of the debtor, there is no continuation of the debtor's business upon the trustee's appointment, and therefore, no underwriting of the honesty of strangers. SIPA §78fff(a)(4). Upon appointment of the trustee, the debtor is expressly prohibited from engaging in business. §78jjj(b). From the time of the Trustee's appointment, the debtor no longer has employees whose acts are covered under the bond. Thus, as in the current case, a SIPA trustee's claim is based on losses caused by employees retained by the officers whose honesty was assessed by the insurer in underwriting the bond. Otherwise stated,

the losses are the very ones which the insurer contracted to insure.

Finally, the Association also incorrectly concludes that the Trustee's claim under the bond is an attempt to have NUFIC satisfy losses that otherwise would be satisfied by SIPC. *Amicus* brief at 19. Plainly, SIPA does not contemplate that SIPC funds take the place of a debtor's estate. Thus, to the extent of its advances to satisfy the claims of customers, SIPC is subrogated to those customers' claims against, among others, the estate. SIPA §78fff-3(a). See *In re Bell & Beckwith*, 937 F.2d 1104, 1106-1110 (6th Cir. 1991). Moreover, there is no protection under SIPA either for customers whose claims exceed the monetary limits of SIPA protection or for general creditors. *SIPC v. Associated Underwriters, Inc.*, 423 F.Supp. 168, 170-173 (D. Utah 1975). Those categories of creditors also potentially share in any proceeds recovered under a bond.

CONCLUSION

For the foregoing reasons, the motion of American Insurance Association for permission to file an *amicus curiae* brief should be denied.

Respectfully submitted,

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Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

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OPPOSITION OF RESPONDENTS TO MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE OF THE SURETY ASSOCIATION OF AMERICA IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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PRELIMINARY STATEMENT

Pursuant to Rule 37.4 of this Court, John R. Camp, Jr., the Trustee for the liquidation of Government Securities Corporation ("GSC" or "Debtor"), and the Securities Investor Protection Corporation ("SIPC") submit this opposition to the motion of the Surety Association of America ("the Surety Association") for

permission to file an *amicus curiae* brief in support of the petition for a writ of certiorari in this case.[1] The Surety Association is the second trade group to seek to participate as an *amicus* in this matter. The American Insurance Association ("American Insurance") which, like the Surety Association, has never before appeared in this case, filed a motion, which the Trustee and SIPC opposed.[2] Like American Insurance, the Surety Association raises no relevant matter. By relying on inapplicable bank and thrift statutory and case law, the Surety Association not only confuses the issue, but revisits ground that already has been thoroughly covered by the parties. See National Union Fire Insurance Co. of Pittsburgh, PA. ("NUFIC") Petition for Writ of Certiorari, at 3-21, and Respondents' opposing brief, dated January 15, 1993 ("Opposition to Cert. Pet."), at 6-21. Moreover, the Surety Association seeks to raise new issues relating to the nature of the "property of the estate" in this case which have never been advanced, or considered by any court below. These new issues warrant no consideration, not only because of their untimeliness, but because they involve self-serving characterizations of the property that have no basis in the law.

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[1] Motion for Leave to File Brief *Amicus Curiae* of the Surety Association of America In Support of Petition for Writ of Certiorari, dated January 13, 1993. References herein to the motion shall be to "Surety motion," and to the brief, "Surety brief".

[2] Opposition of Respondents to Motion of American Insurance Association for Permission to File *Amicus Curiae* Brief, dated January 21, 1993 ("Opposition to American Insurance Mtn."). Because a brief overview of this matter is contained at page 2 of that Opposition, it will not be repeated here.

For these reasons, as discussed more fully below, the Surety Association's motion should be denied.

ARGUMENT

1. The Bank and Thrift Cases Are Irrelevant.

The differences in the statutory authority of SIPC and the Federal Deposit Insurance Corporation, and the inapplicability of bank and thrift law to this case have been discussed extensively by the Trustee and SIPC. Opposition to Cert. Pet. at 6-21.[3] The Surety Association sheds no new light on the question, instead devoting much of its argument to the alleged consequences of a failure to uphold the the termination clause. It postulates in that event, that fidelity bond availability "will be diminished to a large extent, if indeed [it does] not vanish from the marketplace altogether." Surety brief at 15. In fact, if the clause is not upheld, insurers might simply increase their premiums. Thus, the long-term effect forecast by the Surety Association is far from certain. More significantly, the impact upon the insurance industry, if any,

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[3] The Surety Association errs in asserting that SIPC requires all brokers to be members of the National Association of Securities Dealers ("NASD"). Surety brief at 2, n.4. In fact, not all brokers that are members of SIPC are also members of the NASD. Brokers or dealers that effect transactions only on a national securities exchange need not register with the NASD. If registration is required, it is pursuant to section 15(b)(8) of the Securities Exchange Act of 1934, 15 U.S.C. §78o(b)(8), and not pursuant to the Securities Investor Protection Act, 15 U.S.C. section 78aaa *et seq.* ("SIPA"). See Opposition to Cert. Pet. at 13.

References hereinafter to SIPA shall be to the United States Code, but for convenience, will omit "15 U.S.C."

is not the concern of this Court. Congress has articulated different policies in the securities and banking areas. While a trustee for a failed broker or dealer may recover under a bond pursuant to section 541(c)(1)(B) of the Bankruptcy Code, 11 U.S.C. §541(c)(1)(B), and SIPA section 78fff(b), a bank receiver or conservator specifically may not, under 12 U.S.C. section 1821(e)(12)(A). See Objection to American Insurance Mtn. at 3-4. If a different policy is to be established with respect to stockbrokers, it is for the Congress, and not the courts, to decide. See *Denver Union Stock Y. Co. v. Producers L.M. Ass'n.*, 356 U.S. 282, 289 (1958) (court should "guard against the danger of sliding unconsciously from the narrow confines of law into the more spacious domain of policy"); *New Jersey v. Anderson*, 203 U.S. 483, 490 (1906) (province of court is to enforce, and not to make, laws); *Zenith Radio Corp. v. Matsushita Electric Industrial Co.*, 494 F.Supp. 1161, 1177-78 (E. D. Pa. 1980) (court is not to "become involved in questioning propriety of [law]"). The Surety Association's contentions in this regard simply are irrelevant.

2. The "Property of the Estate" In This Matter Consisted of the Fidelity Bond With All of the Rights Afforded by Law.

Likewise, American Surety's characterizations of the property interest at hand are inaccurate, and raise no issue worthy of review. On the one hand, American Surety asserts that the Debtor's only property interest consisted of a right to the return of any unused premiums and a right to recover on any claims filed prior to the "termination" of the bond. In its view, those rights persisted notwithstanding the debtor's liquidation, and therefore, section 541(c)(1)(B) could

not be deemed to apply. Surety brief at 8-10. Alternatively, American Surety maintains that the only property interest held by GSC was a terminated bond.[4] It contends that section 541(c)(1)(B) would not apply in that situation either, because, in effect, there was no bond of which the Trustee could take possession. *Id.* at 10.[5] Preliminarily, inasmuch as the arguments were never raised or considered below, application of the general rule that federal appellate courts do not review issues not passed upon by the lower courts, is appropriate. *Duignan v. United States*, 274 U.S. 195, 200 (1927); *Hormel v. Helvering*, 312 U.S. 552, 556 (1941); *Singleton v. Wulff*, 428 U.S. 106, 120 (1976). Even assuming, *arguendo*, that the issues had been timely raised, they warrant no consideration because they are clearly without merit.

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[4] In support of its assertion that the standard stockbroker bond (Form 14) has contained a termination clause since 1936, Surety brief at 4-5, American Surety has appended to its brief, sample bonds from 1936 and 1987 (Appendix C and E). It neglects to mention that although the standard bond that was in effect from at least 1970 until 1987, contained a provision terminating the bond upon the taking over of the insured by a liquidator, the bond also authorized the liquidator to purchase an additional period within which to discover any loss, and effectively, to assert a claim. See Opposition to Cert. Pet. at 18-19. Thus, although American Surety seeks to convey the impression that the termination clause contained in the NUFIC bond continuously has been the *status quo*, in fact, for a period of at least 17 years, it was not.

[5] This argument is unavailable inasmuch as NUFIC effectively has conceded, under a stipulation dated October 28, 1989, between the Trustee and it, that a bond exists and that NUFIC is liable under it if section 541(c)(1)(B) ultimately is deemed to apply.

The characterization of the Debtor's interest in the bond, under either alternative proposed by the Surety Association, finds no support in the law. American Surety does not dispute that insurance contracts, such as the one at hand, constitute property of the estate. *See A. H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001-1002 (4th Cir.), *cert. den.*, 479 U.S. 876 (1986); and Surety brief at 8 ("It is a given that a fully paid insurance policy is a valid and binding contract between Petitioner and GSC, and therefore constitutes *property* of the bankruptcy estate.") It is plain that the property interest is not the selective portions of the bond relied upon by American Surety which further NUFIC's interests, but a bond which includes all of the rights in it that are conferred by operation of law. Thus, in asserting that the Debtor's only interest in the bond consisted of premiums and the right to recover under claims filed prior to the "termination" of the bond, American Surety ignores the important property interest which the termination clause would destroy, and which section 541(c)(1)(B) would preserve—the right of the Debtor, so long as the bond has not been terminated, to discover past losses and file claims thereon. This, of course, is the very property interest that is the object of this litigation. By the same token, in asserting alternatively that the Debtor's interest is in a terminated bond, American Surety presupposes that section 541(c)(1)(B) does not apply. Yet, that assumes, before the fact, an answer to the very question that is being resolved.

In the final analysis, by reason of section 541(c)(1)(B) and SIPA section 78fff(b), the property of the estate in this case includes a fidelity bond with an ineffective termination clause. Any other inter-

pretations, such as those advanced by American Surety, ignore the applicable law.

CONCLUSION

For the foregoing reasons, the motion of American Surety Association for permission to file an *amicus curiae* brief should be denied.

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REPLY TO CAMP AND SIPC'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. RESPONDENTS' "COUNTERSTATEMENT" OF THE QUESTION PRESENTED IS IMPROPER.

Supreme Court Rule 14(a) requires the statement of questions presented to be "concise" and not "argumentative." Respondents, however, preface their "Counterstatement" with the better part of a page of factual argument. Respondents then phrase the Counterstatement in a way which presumes that one of the threshold legal questions presented in this case, whether there is "consistency" between SIPA and 11 U.S.C. § 541(c)(1)(B), has *already* been decided in their favor. More important, Respondents wholly ignore the other question presented for review: whether they are bound to the terms of a standard bond which SIPA required and SIPC requested and approved. Although Respondents pretend this issue does not exist, they devote a significant portion of their brief to arguments bearing upon this very issue.

National Union's initial statement of the questions presented should stand.

II. RESPONDENTS HAVE MADE SEVERAL MATERIAL MISSTATEMENTS CONCERNING THE ISSUE OF GOVERNMENT APPROVAL OF THE STANDARD BOND, INCLUDING THE IMMEDIATE TERMINATION PROVISION AT ISSUE IN THIS CASE.

A. Respondents Have Ignored the Holdings of Cases on Point With the Present Case.

Respondents have ignored well established case law holding that the government and the entities through which it acts are bound by contracts which they approve and require. This principle has been established against the FDIC and FSLIC under facts identical to those of the present case in the cases of *California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556 (9th Cir. 1991); *FDIC v. Aetna Casualty and Surety Co.*, 903 F.2d 1073

(6th Cir. 1990); *Sharp v. FSLIC*, 858 F.2d 1042 (5th Cir. 1988).

The Fifth Circuit has, on January 27, 1993, reaffirmed the principles first set forth in *Sharp*. In *United States Fire Ins. Co. v. FDIC*, ___ F.2d ___, 1993 W.L. 3850 (5th Cir. 1993), a savings and loan carrying the Standard Bond failed and was taken over by state authorities. The FDIC later presented a claim for losses discovered after the takeover. Again, the FDIC argued that the termination clause was against "federal law and public policy." *Id.* at p. 2. The court, again emphasizing that the FDIC had required use of the Standard Bond, stated that "*Sharp* resolves the FDIC's argument regarding public policy [and] enforceability of § 11(c)." *Id.* Thus, *United States Fire* joins a long line of cases recognizing a public policy supporting the immediate termination clause. The case also reaffirms that the government cannot, during a liquidation proceeding, set aside contracts which it has required pursuant to regulation.

Respondents, without attempting to address the factual identity between the *Sharp* cases and the present case, make a brief attempt to distinguish them by calling them "banking law" while this case is "bankruptcy law." Respondents evidently acknowledge that, were the reasoning of the cases to apply, they would have no justification for their position.

The Respondents' characterization of the cases as "banking law," however, finds no support in the cases themselves. The rationale of governmental fairness and consistency is not limited to the context of bank regulation. Certainly, the cases do not suggest such a limited reading of their reasoning. As noted on pages 12 through 19 of the Petition, the issue in the *Sharp* cases was not "banking" versus "bankruptcy," but was consistency between governmental regulatory actions with governmental positions during liquidation proceedings. The whole point of the *Sharp* cases was that it does not matter from where the government's liquidation powers derive, or how broad they are; they must be exercised consistently with action taken pursuant to regulation. Where the government

requires regulated entities to carry standard bonds, the government is bound by all provisions of those bonds.

Respondents ultimately do not address the direct conflict between the *Sharp* cases and the Eleventh Circuit's reasoning. Although they purport to believe that there is no conflict, they spend over five pages of their brief trying to deny the facts which bring them squarely within the application of the *Sharp* decisions: their approval and requirement of the bond at issue in this case.

B. The Termination Upon Takeover Clause Was Part of the Standard Bond Required by SIPA.

Respondents argue that "SIPC" did not require the bond and therefore is not bound to its terms. *SIPA*, however, did require the bond and SIPC, therefore, is indeed bound to its terms.

SIPA regulates all SIPC members through the following steps. First, SIPA requires all SIPC members to be members of SROs, with the intent to impose the extant body of SRO regulations on SIPC members. § 78iii(c). *See also* Opp.Br. at 13-14. Second, SIPA makes SIPC an advisory body to the SROs for the purpose of determining where new rules might be needed and requesting the SROs to develop such rules, in large part to improve financial responsibility of SIPC/SRO members. § 78iii(e). Third, the SRO's have final responsibility for promulgating and enforcing financial responsibility rules. § 78iii(c).

In the present case the process worked as follows. GSC was required to be a member of NASD, and was thus subject to NASD's rules. In 1970, SIPC advised NASD that bonds were needed to improve the financial stability of SIPC members, and specifically requested NASD to require such bonds. NASD, with SIPC's full knowledge, developed such rules in conjunction with the surety companies, and required members to carry a bond

substantially similar to the Surety Association of America's standard form Stockbroker's Blanket Bond which contained the termination upon takeover clause. Once this rule was effective, it was a requirement of SIPA, through NASD as SIPA's Congressionally-designated regulator of GSC.

Thus, SIPC's arguments that it did not "approve" the termination clause are legally irrelevant. *NASD*, not SIPC, was GSC's governmentally-designated regulator, and it was NASD, in this role, which required the standard bond. Cases uniformly recognize that governmental (in this case Congress through NASD) requirement of the use of a standard bond establishes as a matter of law governmental approval of the bond "and all of its provisions." *California Union Ins. Co. v. American Diversified Savings Bank*, 948 F.2d 556, 562 (9th Cir. 1991). Since SIPC's role was strictly advisory, and NASD's role was regulatory, SIPC's approval is legally irrelevant to the demonstrable governmental approval of the bond.

For this reason, Respondents' cursory statement that SIPC is not an "agency" of the federal government is not only wrong (for the reasons stated by others), but also irrelevant, because the "agency" requiring the standard bond is NASD,[1] not SIPC.

C. Respondents' Arguments that SIPC Never Approved of the Immediate Termination Provision Are Based on Incorrect Factual Statements.

On pages 19 and 20 of its brief and in footnote 12, Respondents make a factual statement that the immediate termination provision at issue in this case was added by rider in 1980 and by amendment to the standard bond in 1987. Thus, Respondents argue, SIPC never approved of

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[1] It should be noted that SIPA § 78iii explicitly makes SROs agents of the government for the purpose of collecting SIPC assessments and enforcing financial responsibility rules under SIPA.

that provision when it approved of the standard bond in 1971. This entire argument is based upon a direct misstatement of fact.

In fact, the termination provision at issue here was part of the standard bond extant in 1970 and 1971, when SIPC requested and approved of NASD's requirement that it be carried by all SIPC members, and has been part of the standard bond since *1936*. Respondents did not support their argument with any evidence. National Union, therefore, is attaching as an appendix the text of the termination clauses contained in the 1970 Stockbrokers Blanket Bond and the 1987 Financial Institution Bond. As can be seen, the immediate termination provisions of the 1970 bond (para. 11(c)) and the 1987 bond (para. 12(c)) are identical.[2]

Respondents are attempting a misdirection play by confusing the issue of "tail" coverage with the issue of immediate termination. The provision which was added by rider in 1980 and by amendment in 1987 was the provision eliminating the trustee's right to purchase an additional discovery period. This is an entirely separate and distinct provision from the immediate termination clause. It is true that SIPC did not approve of its loss of the right to purchase additional coverage. However, this disapproval in itself shows SIPC's consistent position over the years in *recognizing* the force and effect of the immediate termination clause.[3]

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[2] Since Respondents went outside the record to make their argument, National Union assumes that they have no objection to National Union presenting, in the appendix, the documents which establish the true state of affairs.

[3] As Respondent's note, an appeal involving the same issues presented in this case is pending in the Fourth Circuit. Opp.Br. at 6. In that appeal, SIPC has appended to its brief a letter dated November 10, 1977 from SIPC's Chairman to the President of NASD. The letter concerned a proposed rider to the

D. Respondents Concede that SIPC has Always Recognized the Validity and Known the Effect of the Immediate Termination Provision.

Respondents, in making their misdirected argument concerning "tail" coverage, concede the primary point of this case: that SIPC has always recognized and acknowledged that, under the standard Securities Dealers Blanket Bond at issue in this case, coverage terminates upon the appointment of a SIPA liquidator. Respondents begin by asserting on pages 18 and 19 of the Opposition Brief that, prior to 1987, the bond would not have been objectionable to SIPC because there was a provision which "permitted a trustee to make recovery under it." Although the incorrect implication is SIPC was innocent of the bond's immediate termination provision (see *supra*), the full text of provision relied upon is more revealing.

What the bond really authorized was for "the liquidator *to purchase* an additional period within which to discover" losses. Opp.Br. at 18 (emphasis added). Indeed, the quoted bond provision only allowed the liquidator to obtain limited additional coverage – an additional period to discover loss occurring *prior* to liquidation – and stated

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bond which would eliminate the right of the trustee to purchase the additional coverage period. SIPC stated that:

> Indeed, to the extent such a provision became common in policies of this type, SIPC would, in effect, become the underwriter for theft and embezzlement which occurred during a broker-dealer's operations but which were not discovered until after a SIPC trustee was appointed to liquidate the firm.

By this language, SIPC expressly recognized the validity and effectiveness of the termination upon takeover provision. Indeed, SIPC never objected to the immediate termination of coverage, only of its possible loss of the right to purchase additional coverage. This Court should take judicial notice of SIPC's position in other courts on this issue, especially when SIPC documents submitted as part of the briefs materially contradict SIPC's legal arguments in this Court.

that the liquidator *"shall pay an additional premium therefor." Id.* Most important, the quoted provision itself states that the trustee's right to purchase this "tail" coverage only comes into play "if this bond is terminated or canceled as an entirety *by reason of the taking over of the insured by a . . . liquidator." Id.*

Thus, Respondents have acknowledged that, really, SIPC has always known how the immediate termination provision worked. Since Respondents admit that this regime "would not have been objectionable to SIPC," they concede that the termination clause was effective. In addition, Respondent's recognition that extended coverage must be *paid for* demonstrates that the option to extend coverage was a valuable property right belonging to the insurer and not a statutory right belonging to SIPC and its trustees.[4] The inevitable conclusion is that SIPC recognizes and has always recognized that SIPA's reference to the Bankruptcy Code did not permit SIPC trustees to void the termination clause. No other construction of Respondents' argument is possible.

Finally, SIPC's statements should not make this Court lose sight of what SIPC is trying to obtain. SIPC is seeking much more than simply an additional "discovery period" for losses occurring under the old management. SIPC, if successful, will also obtain forced insurance for losses arising from dishonest acts of employees during the liquidation period.[5] Respondents do not explain this

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[4] The issue of SIPC attempting to take from insurer's valuable contractual rights is fully addressed by *amicus*. SIPC's statements fully reinforce the arguments of *amicus* that taking from insurers additional coverage without compensation violates the Constitution.

[5] Respondents misstate how the bond works, apparently in an attempt to soften the impact of SIPC's taking of additional insurance coverage. At page 6 of their Brief in Opposition to the *amicus* brief of Surety Association of America, Respondents assert that the only "property" interest taken is the right to

fact, or that SIPC would obtain through judicial fiat far more coverage than it was *ever* entitled to purchase in the past.[6]

E. Respondents Mischaracterize National Union's Arguments Concerning the Extent to Which SIPA Incorporates the Bankruptcy Code.

Respondents state that National Union argued that only those Code provisions specifically mentioned in SIPA are incorporated, thus rendering § 78fff meaningless. This is not true.

SIPA § 78fff incorporates the procedural provisions of the Bankruptcy Code to the extent they are consistent with SIPA. Substantive provisions are not incorporated unless either SIPA or the Bankruptcy Code specifically so

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discover "past losses." This is manifestly incorrect; if the bond continues in its entirety, as Respondents later claim, then they also obtain coverage for acts occurring and discovered during the liquidation period.

[6] Respondents again misstate how the bond works. At page 6 of their Brief in Opposition to the Insurance Association of America's *amicus* brief, they state that coverage for post-liquidator losses ceases because the insured ceases to engage in continued business transactions. Again, this is not correct; the bond covers dishonest employee acts and is not conditioned upon "doing business." So long as the company has any assets and any employees, there is the potential for covered losses occurring, even during liquidation.

Also, such a period is the period of greatest risk. The demoralization, confusion and loss of supervision arising upon involuntary liquidation provide *both* greater temptation and greater opportunity for employee theft. Cases consistently recognize that the increased risk under these circumstances is legal justification for the immediate termination provision in fidelity bonds. *FDIC v. Aetna Casualty and Surety Co.*, 903 F.2d 1073, 1078 (9th Cir. 1990), *Sharp v. FSLIC*, 858 F.2d 1042, 1045-46 (11th Cir. 1988). Even under the "tail" coverage available to trustees prior to 1980, the insurers never agreed to provide any coverage for this highest-risk period.

state. This is what the *Securities and Exchange Commission v. Aberdeen Securities Co., Inc.*, 526 F.2d 603 (3d Cir. 1975) and *Redington v. Touche Ross & Co.*, 612 F.2d 68 (2d Cir. 1979) cases held. These cases are consistent with the fact that many provisions of SIPA specifically incorporate specific substantive provisions of the Bankruptcy Code, a situation which would not be necessary if they were already incorporated by § 78fff.

F. Respondents Distort the "Plain Meaning" of § 78fff.

Respondents assert that the plain meaning of § 78fff is that all referenced provisions of the Code are incorporated into SIPA by reference. The Eleventh Circuit also adopted this "blanket incorporation" approach. Section 78fff, however, states that SIPA liquidations are "conducted" in accordance with the Bankruptcy Code. The *Aberdeen Securities* and *Touche Ross* cases both held that this explicit reference to "conduct" shows that Congress only intended to refer to Bankruptcy *procedures*. Thus, Respondents' assertions notwithstanding,[7] there is direct conflict between the Eleventh and the Second and Third Circuits on this point. In addition, Respondents' related argument that the only qualification placed on incorporation of the Code is "consistency" is manifestly incorrect, and has been expressly rejected by two courts.[8]

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[7] The fact that the three cases involved different factual situations involving the application of different Code provisions does not at all mean there is no conflict between the Courts. In each case, the extent of the Code's incorporation into SIPA was an issue requiring consideration in order for the courts to reach their final decisions.

[8] Respondents claim that the *Touche Ross* and *Aberdeen* cases can be interpreted as cases evaluating "consistency" between SIPA and the Code. Such a reading, however, necessarily ignores the plain language on the face of the opinions, as Respondents acknowledge on page 29 of the Opposition Brief.

Respondents also assert that § 78fff only prohibits use of Code provisions which conflict with an "explicit provision" of SIPA. Section 78fff, however, states that application must not be inconsistent with "other provisions of this Chapter." Respondents acknowledge, on pages 13 and 14 of the Opposition Brief, that one of SIPA's primary purposes it to have the SRO's upgrade financial responsibility rules and impose those rules on SIPC members. Given this admission, it is inconceivable that, where other provisions of SIPA impose regulations upon SIPC members, Code provisions may be used to override those regulations just because the full text of the regulations is not "explicit" in the language of SIPA itself.

CONCLUSION

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA. respectfully submits that the Petition for Certiorari should be granted.

Respectfully submitted,

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The reasoning of the cases focused on procedural versus substantive incorporation, not consistency. It is this type of direct conflict between Circuits which is a recognized basis for certiorari review.

1970 STOCKBROKERS BLANKET BOND

TERMINATION OR CANCELLATION

Section 11. This bond shall be deemed terminated or canceled as an entirety – (a) thirty days after receipt by the insured of a written notice from the Underwriter of its desire to terminate or cancel this bond, or (b) immediately upon the receipt by the Underwriter of a written request from the Insured to terminate or cancel this bond, or (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another business entity. The Underwriter shall, on request, refund to the Insured the unearned premium, computed pro rata, if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Underwriter, or if terminated or canceled as provided in sub-section (c) or (d) of this paragraph. The Underwriter shall refund to the Insured the unearned premium computed at short rates if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Insured.

1987 FINANCIAL INSTITUTION BOND

TERMINATION OR CANCELATION

Section 12. This bond terminates as an entirety upon occurrence of any of the following: (a) 60 days after the receipt by the Insured of a written notice from the Underwriter of its desire to cancel this bond, or (b) immediately upon the receipt by the Underwriter of a written notice from the Insured of its desire to cancel this bond, or (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another institution, or (e) immediately upon exhaustion of the Aggregate Limit of Liability, or (f) immediately upon expiration of the Bond Period as set forth in Item 2 of the Declarations.

MOTION FILED

JAN 7 1993

No. 92-1046

In The

Supreme Court of the United States

October Term, 1992

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,

Petitioner,

v.

JOHN B. CAMP, TRUSTEE, SECURITIES INVESTOR PROTECTION CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

MOTION TO FILE BRIEF OF AMICUS CURIAE AND BRIEF OF AMICUS CURIAE AMERICAN INSURANCE ASSOCIATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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MOTION TO FILE BRIEF OF AMICUS CURIAE AMERICAN INSURANCE ASSOCIATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I. INTEREST OF AMICUS CURIAE

The American Insurance Association is a trade association with over two hundred and fifty members and representation in every state. The members of AIA are major property/casualty insurers, and include most of the largest writers of fidelity bonds in the United States.

Under the express terms of the fidelity bond at issue here, the bond unquestionably does not cover a loss for which the government, acting through the Securities Investor Protection Corporation ("SIPC"), seeks coverage. Upon application of the SIPC, the lower courts held invalid the contractual provision of the insuring agreement that precludes coverage, and entered a judgment for $500,000 (the full amount of the bond) against the insurer. The judgment, if affirmed, would be used to pay claims that otherwise would be paid from a fund maintained by SIPC and mandated by Congress.

AIA and its members are gravely concerned about the prospect of governmental and judicial rewriting of lawful and unambiguous insurance contracts in the government's self-interest. In this instance, the rewrite would impose liability upon an insurer under circumstances where the contracting parties had plainly agreed there would be no coverage.

II. NEED FOR ADDITIONAL BRIEFING

Petitioner argues that the lower courts misconstrued the relevant federal statutes and decisional law. AIA believes, in addition, that the government's action raises an important constitutional issue that has not been briefed by petitioner.

AIA respectfully moves for leave to file the attached brief amicus curiae, which addresses the constitutional issue, as well as statutory issues not briefed by petitioner.

The consent of the attorneys for respondent was requested but refused.

Dated: January 7, 1993.

Respectfully submitted,

SEDGWICK, DETERT, MORAN & ARNOLD

By _____

FREDERICK D. BAKER
Attorney for Amicus Curiae American Insurance Association

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BRIEF OF AMICUS CURIAE AMERICAN INSURANCE ASSOCIATION

I. INTRODUCTION AND SUMMARY OF ARGUMENT

This is an action to recover on a fidelity bond written by National Union to protect GSC, a securities dealer, from losses caused by dishonest acts of GSC's officers and employees.

A fidelity bond is a unique instrument, entirely unlike a commercial lease, or an agreement to provide goods or services, or any other routine business contract. One who issues a fidelity bond to a financial institution such as a bank, a savings and loan, or a securities dealer, does so on the basis of a very subjective assessment of the integrity of those who control the institution. Risk is calculated based on the insurer's trust in the honesty of the officers of the institution, and their ability to hire trustworthy employees and to carefully supervise their work.

Because the agreement is so closely tied to the insurer's trust in the integrity of the particular individuals who control the institution, the standard fidelity bonds written for financial institutions provide that they terminate immediately if the institution is taken over by some third party. The bond at-issue here, which is a standard form document, provides that it terminates immediately if GSC is taken over by another business entity, by state officials, by federal officials, or by a receiver or other liquidator.

The critical importance of the automatic termination upon takeover provision is facially apparent. No insurer is willing to underwrite the honesty of strangers. As the courts have recognized, once the institution has been taken over by third parties the risk which formed the basis of the agreement has been fundamentally and drastically altered.[1] To require those who issue fidelity bonds to insure the honesty of unknown third parties is to impose upon them a substantial burden for which they did not contract, for which they did not bargain, and for which they received no consideration.

GSC was taken over by a liquidator. The lower courts have ruled that the express and unambiguous provision of the agreement, which states that the bond terminates immediately if the institution is taken over by (among others) a liquidator, is meaningless and unenforceable. They did so on the basis of a provision in the Securities Investors Protection Act ("SIPA") which incorporates, wholesale, the procedures of the Bankruptcy Code when a securities dealer is liquidated. A substantive, not procedural, provision of the Bankruptcy Code, known as the "anti-ipso-facto" provision, states that a liquidator may enforce an agreement "notwithstanding any provision . . . conditioned on the insolvency or financial condition of the debtor . . . or on the appointment of or taking possession by a trustee . . . that effects . . . a termination of the debtor's property."[2]

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[1] *Sharp v. FSLIC*, 858 F.2d 1042, 1045-46 (5th Cir. 1988).

[2] 11 U.S.C. § 541(c)(1)(B).

Congress has never spoken on the enforceability of the automatic termination provision with specific reference to a securities dealer's fidelity bond. Long after SIPA was enacted in 1970, however, Congress did speak to the issue in the case of banks and savings and loans. In 1989, Congress closely focused on the issue of financial institution liquidation and enacted legislation establishing detailed procedures rather than, as SIPA had done, simply incorporate bankruptcy procedures. The legislation included an "anti-ipso-facto" provision, like that in the Bankruptcy Code, which states that a bank or savings and loan liquidator "may enforce any contract . . . notwithstanding any provision . . . for termination . . . by reason of insolvency or the appointment of a [liquidator].[3] Congress expressly excepted, however, fidelity bonds from the class of contracts that liquidators may enforce notwithstanding automatic termination provisions.[4]

Standard form fidelity bonds, which include the automatic termination upon takeover provision, predate SIPA and other federal statutes that regulate the financial services industry. Congress required financial institutions to purchase standard form fidelity bonds with full knowledge they provided for automatic termination upon takeover. The automatic termination provision is a valuable contract right held by those who issue fidelity bonds.

Freedom of contract and the enforcement of lawful contracts are matters of paramount public importance. Courts may not interfere with the performance of lawful

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[3] 12 U.S.C. § 1821(e)(12)(A).

[4] *Ibid.*

contracts in the absence of clear, explicit, well-defined, and dominant authority. Article I, section 10 of the Constitution prohibits states from impairing the obligation of contracts. It has been held that the Fifth Amendment's prohibition of taking property for public use without due process or just compensation embraces this principle with regard to actions of the federal government.

When SIPC stripped National Union of its lawful contractual termination rights, it took National Union's property as surely as if it had seized the insurer's real property. This taking without just compensation violates the Fifth Amendment.

II. ARGUMENT

A. NO AUTHORITY JUSTIFIES INVALIDATION OF THE AUTOMATIC TERMINATION PROVISION

In *St. Paul Mercury Ins. Co. v. Duke University*, 849 F.2d 133, 135 (4th Cir. 1988) the court observed that "our commercial system depends on the ability of parties to contract with certainty. Were courts free to refuse to enforce contracts as written on the basis of their own conceptions of the public good, the parties to contracts would be left to guess at the content of their bargains, and the stability of commercial relations would be jeopardized."

Nearly a century ago the Court recognized that "the usual and most important function of courts of justice is to maintain and enforce contracts rather than to enable parties thereto to escape from their obligations on the

pretext of public policy, unless it clearly appear that they contravene public right or the public welfare . . . [Y]ou have this paramount public policy to consider, – that you are not lightly to interfere with this freedom of contract."[5] "Public policy is to be ascertained by reference to the laws and legal precedents . . . there must be found definite indications in the law of the sovereignty to justify the invalidation of a contract as contrary to that policy. It is a matter of public importance that good faith contracts of the United States should not be lightly invalidated. Only dominant public policy would justify such action."[6]

Here the lower court invalidated the automatic termination provision on statutory rather than public policy grounds, but the same general considerations apply. The bond is a good faith and lawful contract between National Union and GSC. It is a standard form fidelity bond that is required by the federal government (including the automatic termination provision) (15 U.S.C. § 78iii, NASD ¶¶ 2182, 2182A; 12 C.F.R. § 563.19), both for securities dealers and for other financial institutions.

Because the bond is a lawful contract, which National Union reasonably believed would be enforced according to its terms, and which in a very real sense bears the

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[5] *Baltimore & Ohio Southwestern Ry. v. Voigt*, 176 U.S. 498, 505-06 (1900) (citation and internal quotation omitted).

[6] *Muschany v. United States*, 324 U.S. 49, 66 (1945). *See also United Paperworkers International Union v. Misco, Inc.*, 484 U.S. 29, 42 (1987); *W.R. Grace & Co. v. Rubber Workers*, 461 U.S. 757, 766 (1983); *Sabine Corp. v. Ong Western, Inc.*, 725 F.Supp. 1157, 1183 (W.D. Okla. 1989).

imprimatur of the federal government, a critical provision of the bond may not be invalidated on statutory grounds unless the statute on which the court bases its authority clearly, and in a well-defined and explicit manner, applies to the contractual provision at-issue. It cannot reasonably be said that the statutes relied upon by the lower courts here were clearly and explicitly intended by Congress to invalidate an automatic termination upon takeover provision in a standard fidelity bond.

As petitioner has shown, the courts have upheld the enforceability of the automatic termination provision in the context of fidelity bonds written for banks and savings and loans.[7] Petitioner has discussed a principal basis for these decisions; the federal government has required these institutions to purchase a standard form bond that includes an automatic termination provision. As the Ninth Circuit found: "[W]e conclude that the Form 22 bond, with all of its provisions [including the automatic termination provision], is endorsed by the federal government by way of the federal agency responsible for the regulation of the savings and loan industry . . . through its requirement that the Standard Form 22 bond be used."[8]

Federal regulation of consumer protection in the securities field parallels (albeit with less direct federal intervention) the statutory scheme established for banks

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[7] Petition at 12-17.

[8] *California Union Ins. v. American Diversified Sav.*, 948 F.2d 556, 562 (9th Cir. 1991). *See also Sharp*, 858 F.2d at 1043.

and savings and loan associations. SIPA created the Securities Investor Protection Corporation ("SIPC") which, like the Federal Deposit Insurance Corporation ("FDIC") and the late FSLIC, insures customers against loss if a financial institution, and in the case of SIPC a securities dealer, fails.[9]

Congress gave SIPC oversight authority to regulate securities dealers.[10] Direct responsibility was given to self-regulatory organizations, such as the National Association of Securities Dealers ("NASD"); however SIPC's mandate was to consult and cooperate with self-regulatory organizations for the purpose of establishing and implementing procedures to monitor the activities of securities dealers, and to insure their compliance with applicable financial responsibility rules.[11]

As established by petitioner, NASD, as a body empowered by Congress to regulate securities dealers, required GSC and its other SIPC-insured members to purchase "a blanket fidelity bond, in a form substantially similar to the standard form of Brokers Blanket Bond promulgated by the Surety Association of America."[12] Thus, the Ninth Circuit's holding in *California Union Ins. v. American Diversified Sav.*, 948 F.2d 556 (9th Cir. 1991) fairly may be adapted to the circumstances present here:

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[9] *See Securities Investor Protection Corporation v. Barbour*, 421 U.S. 412 (1975); *Securities Investor Protection Corporation v. Vigman*, 803 F.2d 1513 (9th Cir. 1986).

[10] 15 U.S.C. § 78iii.

[11] *Ibid.*

[12] Petition at 10-11.

> [W]e conclude that the [standard form Brokers Blanket Bond], with all of its provisions [including the automatic termination provision], is endorsed by the federal government by way of the federal agency responsible for the regulation of the [securities dealer] industry . . . through its requirement that the [standard form Brokers Blanket bond] be used.[13]

There is another important reason that the courts have upheld automatic termination provisions in financial institution fidelity bonds. When Congress focused carefully on the issue of liquidation and fidelity bond termination provisions, long after the enactment of SIPA, it determined that automatic termination provisions are enforceable and that liquidators may not seek to invalidate them.

Congress enacted detailed procedures for liquidating banks and savings and loans, and specified with great particularity the authority of liquidators.[14] Congress gave liquidators appointed by the Resolution Trust Corporation broad authority to void limiting provisions in certain contracts, but explicitly denied authority to void coverage-limiting provisions in fidelity bonds:

> The conservator or receiver may enforce any contract, *other than a . . . depository institution bond*, entered into by the depository institution notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of,

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[13] *California Union*, 948 F.2d at 562 (as adapted).

[14] *See* 12 U.S.C. §§ 1821 *et seq.* and enabling regulations.

> insolvency or the appointment of a conservator or receiver.[15]

The courts have held this statutory language shows Congress was aware that financial institutions had obtained fidelity bonds limiting coverage in the event of a takeover, yet specifically excluded such bonds from section 1821's "anti-ipso-facto" provision:

> Continuance of [fidelity bond coverage] after seizure of a bank by FDIC has not been a major concern of the government. It is clear from [12 U.S.C.] § 1828 that Congress is aware of fidelity insurance and could, if it so desired, set terms which would avoid the problem presented by [the automatic termination provision]. *Congress chose to specifically exclude fidelity insurance from the prohibition contained in the new section 1821(e)(12)(A).*[16]

The Ninth Circuit has said that section 1821(e)(12)(A) is

> evidence of *Congress' approval of the termination provisions found in the Standard Form 22 bonds. . . .* We view this amendment [excepting fidelity bonds from the government's anti-ipso-facto powers] as *recognition of a public policy permitting this termination of . . . bond coverage upon takeover* by the government of the failed thrift.[17]

Congress has both expressly and impliedly required financial institutions to purchase standard form fidelity

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[15] 12 U.S.C. § 1821(e)(12)(A) (emphasis supplied).

[16] *FDIC v. Aetna Casualty and Surety Co.*, 903 F.2d 1073, 1077 (6th Cir. 1990) (emphasis supplied).

[17] *California Union*, 948 F.2d at 562-63 (emphasis supplied).

bonds, with full knowledge that the bonds provide for immediate termination upon takeover by a liquidator. Congress has expressed a public policy favoring automatic termination of coverage upon takeover by a liquidator in the savings and loan context. Thus, the issue is reduced to this: Does SIPA's wholesale adoption of bankruptcy procedures for the liquidation of a securities dealer override the focused and considered judgment of Congress favoring the automatic termination upon takeover provision of a standard fidelity bond?

SIPA simply provides that "[t]o the extent consistent with the provisions of [SIPA], a [SIPA] liquidation proceeding shall be *conducted* in accordance with, and as though it were being *conducted* under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of [the Bankruptcy Code.]"[18] The Court of Appeal's conclusion that this provision incorporates into SIPA every substantive provision of the referenced chapters and subchapters of the Bankruptcy Code cannot be supported. "The reorganization procedures of the [Bankruptcy Code] were adopted [by SIPA] to give the trustee the maximum flexibility in managing the affairs of the broker/dealer pending liquidation."[19] Thus, 15 U.S.C. § 78fff(b) was intended by Congress only

> to make the flexible [Bankruptcy Code] *procedures* available for SIPA liquidations. This does not mean that every provision of the [Bankruptcy Code], including provisions not relating

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[18] 15 U.S.C. § 78fff(b) (emphasis supplied).

[19] Statement of Senator Bennett, 116 Cong. Rec. 40905 (December 10, 1970).

> to procedures for the operation of a bankrupt, has been incorporated into the SIPA. *Only those provisions relating to* the *procedures* for conducting the affairs of the estate during bankruptcy administration, except as inconsistent with the provisions of SIPA, have been incorporated.[20]

By no stretch of the imagination can the Bankruptcy Code's anti-ipso-facto provision, 11 U.S.C. § 541(c)(1)(B), be considered a procedural provision governing the conduct of a liquidation proceeding under SIPA. It profoundly affects the substantive rights of parties who enter into lawful and good faith contracts.

SIPA states that Bankruptcy Code procedures *are* incorporated only to the extent they are consistent with SIPA. The government has consistently approved and required fidelity bonds that terminate automatically upon takeover, both under SIPA and under statutes governing other financial institutions. SIPA's requirement of consistency refutes any suggestion that SIPA incorporates the Bankruptcy Code's anti-ipso-facto provision, which is inconsistent with SIPA, and demonstrates beyond question that there is no dominant public policy favoring invalidation of the automatic termination provision.

Moreover, even if we assume, for the purpose of argument, that SIPA incorporates 11 U.S.C. § 541(c)(1)(B), that is scarcely sufficient to invalidate the automatic termination provision in a government-approved fidelity bond.

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[20] *S.E.C. v. Aberdeen Securities Co., Inc.*, 526 F.2d 603, 606 (3d. Cir. 1975) (emphasis supplied in the last sentence).

The following are typical applications of the Bankruptcy Code's anti-ipso-facto provision. *In re Bell*, 700 F.2d 1053 (6th Cir. 1983) involved a debtor who borrowed to purchase a van. The loan agreement provided that the lender was entitled to immediately repossess the van if the borrower filed for bankruptcy.[21] The court said the provision was inoperative under section 541(c)(1)(B) and the van became the property of the estate (until abandoned by the estate).[22] Similarly, *In re Winters*, 69 B.R. 145 (D. Ore. 1986) and *Matter of Bryant*, 43 B.R. 189 (E.D. Mich. 1984) found that a secured creditor's attempt to repossess property pursuant to a bankruptcy clause in the lending agreement is barred by the anti-ipso-facto clause.[23]

In *United Counties Trust Co. v. Knapp*, 137 B.R. 582 (D. N.J. 1992) plaintiff, who had issued a credit card to Knapp, attempted to revoke permission to use the card when Knapp filed for bankruptcy. Charges made after the revocation letter were, plaintiff argued, fraudulent and thus nondischargeable. The court rejected plaintiff's argument, finding the revocation ineffective pursuant to section 541(c)(1)(B).[24] In *Mumpfield v. Leavell*, 140 B.R. 578 (M.D. Ala. 1991) the debtor had entered into a contract to purchase real property. The seller's attempt to terminate the agreement was held by the bankruptcy court to be "a

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[21] *Id.* at 1258.

[22] *Ibid.*

[23] *See also In re Mitchell*, 85 B.R. 504 (D. Nev. 1988) (same).

[24] *Id.* at 585-86.

forfeiture under the terms of the agreement" and thus contrary to the anti-ipso-facto provision.[25]

These are the sort of agreements that the anti-ipso facto provision of the Bankruptcy Code was intended to reach. Typically the debtor has an existing (usually possessory) interest in property; someone else, who has a contingent interest (usually upon default) seeks to bypass the bankruptcy estate and transfer that property interest from the debtor to himself. Without the anti-ipso-facto provision, it would be difficult for many who are insolvent to reorganize. A hardware store owner would have a difficult time getting a fresh start if his landlord could cancel the lease and his delivery trucks could be repossessed.

A fidelity bond simply is not that sort of contract. The bond here, which is a standard form bond, may be terminated in a number of ways. It terminates upon expiration of the bond period, upon written notice by the insurer, upon written request by the insured, upon takeover of the insured by another business entity, and upon takeover of the insured by a receiver or other liquidator or by state or federal officials. Here the focus is on takeover, not insolvency.

The bond covers only losses discovered during the bond period; that is, after the effective date of the bond and prior to termination. Thus, National Union would have been obligated to pay a fidelity loss discovered during its bond period even though the dishonest act occurred before the effective date of the bond. By the

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[25] *Id.* at 580-81.

same token, if the trustee had purchased a fidelity bond for the period of the trusteeship, as he was authorized to do (see 11 U.S.C. § 322; Bankruptcy Rule 2010(a)), then the loss at issue here (which was discovered after the appointment of the trustee) would have been covered under the trustee's bond. The trustee chose not to insure against this risk. The consequences of his choice cannot be imposed equitably upon National Union.

The insured has *no* property interest in any bond proceeds unless a loss is discovered prior to termination. This bond terminated immediately, in accordance with its express terms, when the insured was taken over. GSC did not and could not have had any property interest under the bond for losses discovered after takeover.

The point is illustrated by *Continental Cas. Co. v. Allen*, 710 F.Supp. 1088 (N.D. Tex. 1989). There, the insurer issued a directors' and officers' ("D&O") liability policy to a bank. The policy excluded claims brought by FDIC as a receiver, conservator, or liquidator. (Congress expressly excluded D&O policies, as it did fidelity bonds, from the anti-ipso-facto provision contained in the legislation governing liquidation of banks and savings and loan associations. 12 U.S.C. § 1821(e)(12)(A).) FDIC took over the bank as receiver and liquidator and sued its directors; it challenged the enforceability of the exclusion, claiming that it violated FDIC's "statutory right to marshal and collect assets."[26] The court disagreed:

> FDIC overlooks the very important fact that in order to marshal and collect an asset, the failed

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[26] *Continental Cas. Co.*, 710 F.Supp. at 1099.

> bank must have it as an asset. Here, the bank did not own as an asset directors' and officers' liability insurance without an FDIC [exclusion].[27]

Similarly, GSC did not own as an asset a fidelity bond without an automatic termination upon takeover provision. The provision was triggered immediately upon SIPC's takeover of GSC. From that point forward, GSC had *no* property interest in the bond or its proceeds; there simply was nothing that could have transferred to the estate.

In short: (1) Congress has required the use of a bond containing an automatic termination provision and SIPC cannot complain about its enforceability; (2) when Congress spoke on fidelity bond automatic termination provisions, it declared them enforceable in liquidation proceedings; (3) it is reasonable to infer that had Congress focused on the issue in the context of SIPC proceedings, it would have reached the same conclusion that it did with respect to FDIC and FSLIC proceedings; (4) in light of the "general rule . . . that competent persons shall have the utmost liberty of contracting and that their agreements voluntarily and fairly made shall be held valid and enforced by the courts,"[28] SIPA's wholesale adoption of bankruptcy procedures cannot invalidate substantive rights of contracting parties; (5) Congress did not intend to, and did not, incorporate the Bankruptcy Code's anti-ipso-facto provision into SIPA liquidation

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[27] *Id.* at 1099-1100.

[28] *Twin City Pipe Line Co. v. Harding Glass Co.*, 283 U.S. 353, 356 (1931).

proceedings; and (6) even if it had, the provision would not apply to the automatic termination provision in a Securities Dealer Blanket Bond.

For all of these reasons, the lower courts erred in ruling that the automatic termination provision of the Securities Dealer Blanket Bond is invalid and unenforceable. The lower courts have, by judicial ukase, required National Union to provide coverage for a loss which is not, under the express and unambiguous terms of the bond, a covered loss. This constitutes a taking of National Union's property in violation of the Fifth Amendment.

B. THE LOWER COURT'S RULING VIOLATES THE FIFTH AMENDMENT

The Fifth Amendment of the Constitution embraces the principle, articulated with respect to states in Article I, section 10, that the federal government may not arbitrarily impair contractual rights. "[A] flagrant impairment of contract by a federal governmental body would be forbidden by the due process clause of the fifth amendment of the United States Constitution."[29] "[A] measure of protection against contract impairment is given by the Fifth Amendment."[30]

"The Fifth Amendment commands that property be not taken without just compensation. Valid contracts are property, whether the obligor be a private individual, a

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[29] *Armstrong v. Fairmont Community Hosp. Assoc., Inc.*, 659 F.Supp. 1524 (D. Minn. 1987).

[30] *John McShain, Inc. v. District of Columbia*, 205 F.2d 882 (D.C. Cir. 1953), *cert. denied* 346 U.S. 900.

municipality, a State or the United States."[31] An executory contract is "property within the meaning of the Fifth Amendment."[32]

"The essence of every executory contract is the obligation which the law imposes on the parties to perform it. It [the contract] may be defined to be a transaction between two or more persons, in which each party comes under an obligation to the other, and each reciprocally acquires a right to whatever is promised by the other."[33] These contractual rights come "within [the Fifth Amendment's] protection."[34] Thus, if the federal government takes a valuable contract right, it must pay just compensation.[35]

Contract rights acquired by National Union were the agreement that the bond will terminate immediately upon takeover, and that National Union shall not be liable for any loss discovered after termination. If the federal government took these valuable rights for public use, National Union is entitled to just compensation.

The acts of SIPC plainly constitute acts of the federal government. SIPC was established by, and derives its

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[31] *Lynch v. United States*, 292 U.S. 571, 579 (1934). *See also Far West Federal v. Office of Thrift Supervision*, 746 F.Supp. 1042, 1049 (D. Ore. 1990).

[32] *Omnio Commercial Co., Inc. v. United States*, 261 U.S. 502, 507 (1923).

[33] *Id.* at 510.

[34] *Johnson v. United States*, 79 F.Supp. 208, 211 (Ct. C1. 1948).

[35] *Monongahela Navigation Co. v. United States*, 148 U.S. 312 (1893).

powers from, Congress.[36] When a corporation is created in accordance with, and in furtherance of, federal legislation, and is subject to the control of the federal government, its conduct constitutes "state action" and is subject to constitutional limitations.[37] When SIPC brought this action to take away National Union's contractual termination rights, it did so as an agent of the federal government.

It also is clear that this was a taking for public use. SIPC was created to further SIPA's purpose: "to protect against individual hardship caused to customers of brokerage houses by broker failures, to restore investor confidence, and to upgrade the financial responsibility required of registered brokers and dealers."[38] SIPA was enacted for this reason:

> The serious and persistent financial problems besetting the securities industry in recent months have led to the voluntary liquidations, mergers, receiverships or, less frequently, bankruptcies of a substantial number of brokerage houses. Such failures may lead to loss of customers' funds and securities with an inevitable weakening of confidence in the U.S. securities markets. Such lessened confidence has an effect on the entire economy.[39]

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[36] 15 U.S.C. § 78ccc.

[37] *Mathis v. Opportunities Indust. Centers, Inc.*, 545 F.2d 97, 98 (9th Cir. 1976).

[38] *S.E.C. v. White & Co., Inc.*, 546 F.2d 789 (8th Cir. 1976). *See also Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975).

[39] H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. 1 (1970).

To achieve its goal of strengthening confidence in the securities markets and avoiding adverse effects on the entire economy, Congress established SIPC for the purpose of, among other things, insuring "public customers" from loss "in the event of the financial insolvency of their broker."[40] These insurance proceeds are to be paid, if necessary, from a fund established by SIPA and administered by SIPC.[41]

The SIPC fund, which is backed by authority to borrow $1 billion from the U.S. Treasury, is funded by SIPC member assessments.[42] SIPC is required by law to maintain in its fund an aggregate balance of at least $75 million.[43] The fund no doubt has ample assets to meet its obligations to the customers of GSC.

By seeking to invalidate the automatic termination provision and force National Union to cover losses discovered after takeover, in derogation of the express language of the fidelity bond and the intent of the contracting parties, SIPC attempts to use the assets of National Union to pay customer losses that otherwise would be paid from the SIPC fund. A judgment has been entered in favor of the SIPC trustee, and against National Union, in the amount of $500,000. In a very real sense, this action is an effort by SIPC to transfer this amount from National Union to itself.

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[40] *Ibid.*

[41] *Ibid.*; 15 U.S.C. §§ 78ddd, 78fff-2, 78fff-3, 78fff-4.

[42] 78 U.S.C. § 78ddd.

[43] *Ibid.*

The SIPC fund was created to pay customer losses in the event of the failure of a securities dealer, in the public interest. National Union's fidelity bond was not written for this purpose; to the contrary, it was written to protect the dealer from dishonest officers and employees. By invalidating the automatic termination provision, and thus forcing National Union to pay $500,000 for the performance of a function that Congress intended the SIPC fund to perform, SIPC has appropriated National Union's property for its very public use.

SIPC has taken National Union's property as surely as if SIPC had seized real property owned by National Union, sold it, and deposited the proceeds in the SIPC fund. National Union is entitled to just compensation.

III. CONCLUSION

For the foregoing reasons, the decisions of the lower courts should be reversed.

Dated: January 7, 1993.

Respectfully submitted,

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JAN 13 1993

No. 92-1046

IN THE
Supreme Court of the United States
OCTOBER TERM, 1992

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
Petitioner,
v.
JOHN B. CAMP, TRUSTEE,
SECURITIES INVESTOR PROTECTION CORPORATION,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF THE SURETY ASSOCIATION OF AMERICA IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* OF THE SURETY ASSOCIATION OF AMERICA IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

The Surety Association of America (Amicus) respectfully moves for leave to file the attached brief *amicus curiae* in support of Petitioner's pending Petition for Writ of Certiorari. Amicus fully supports Petitioner's position that its Petition should be granted and that the judgment of the 11th Circuit should be reversed.

The consent of the attorney for petitioner has been obtained.

The consent of the attorney for the respondent was requested but refused.

I. NATURE OF AMICUS INTEREST

The nature of Amicus interest in this case arises from its function as a trade association and insurance rating bureau composed of 635 insurance companies. Since its founding in 1908, Amicus has uninterruptedly served that portion of the insurance industry that develops and markets surety and fidelity bonds by acting as a common agent for its 635 member companies. Through lawful contact with regulators, self-regulating organizations, the public, and the courts, Amicus works to promote a climate in which bonds serve a useful purpose and to assure that bonds are available to the public when requested.

At issue here is a Securities Dealer Blanket Bond issued by Petitioner, an Amicus member. Since 1916 Amicus has cooperatively developed a variety of financial institution fidelity bond forms, such as the type in litigation here, usually in collaboration with industry trade groups representing the purchaser of the contract [e.g., American Bankers Association, United States League of Savings Institutions and National Association of Securities Dealers, Inc. (NASD)] to meet the specific needs of Insureds: The Standard Form 24 for banks, the Standard Form 22 for savings and loan associations; and the Standard Form 14 for stockbrokers and security dealers, among others.

II. SIGNIFICANCE OF THIS LITIGATION

Amicus suggests that the 11th Circuit decision nullifying Section 12(c) of Petitioner's bond providing for its immediate termination upon the taking over of the insured by a receiver or other liquidator in the name of 11 U.S.C. § 541(c)(1)(B) is a case of the first impression, presenting an entirely novel question of law for decision by this Court which cannot be governed by any existing precedent.

A viable market with willing purchasers and providers of fidelity and surety bonds permitting liberty of contract is of vital concern to Amicus. The decision rendered by the 11th Circuit in mistakenly relying on bankruptcy law to reach its decision, severely restricts and impinges upon that liberty and defies and runs counter to accepted principles applicable to the construction of contracts and statutes.

III. POINTS OF LAW TO BE RAISED BY AMICUS NOT RAISED BY THE PARTIES

Amicus wishes to urge two points to this Court, as supportive of the proposition that the 11th Circuit should be reversed and which points Petitioner has not raised, as follows:

POINT I

11 USC § 541(c)(1)(B) HAS NO BEARING ON OR APPLICATION TO THE FIDELITY BOND'S SECTION 12(c) AUTOMATIC TERMINATION PROVISION

A. Termination Of The Bond Did Not And Could Not Prevent Transfer Of Debtor's Interest In Property To The Trustee; Hence, Bond Sec. 12(c) Is Immune To Nullification By 11 U.S.C. § 541(c)(1)(B)

B. As a Congress-Created Insurer, Neither SIPC Nor Its Appointed Liquidator Can Override the Termination Provisions Of A Financial Institution's Fidelity Bond

C. The FDIC Secretary of the Treasury and Attorney General Recognize That 12 U.S.C. § 1821(e)(12)(A) Prevents a Receiver or Conservator From Nullifying the Immediate Termination Provision of a Financial Institution Bond

D. The Accepted Principles of Statutory Construction Support a Reversal of the Lower Court's Holdings

POINT II

MAKING FINANCIAL INSTITUTIONS' D & O POLICIES AND FIDELITY BONDS ALSO COVER THE FINANCIAL FAILURE OF THEIR INSUREDS BY NULLIFYING SELECTED PROVISIONS OF SUCH CONTRACTS CAN ONLY MAGNIFY THE ADVERSE ECONOMIC EFFECTS OF THOSE FAILURES

IV. THE VALUE OF AMICUS TO THESE PROCEEDINGS

The foregoing matters which Amicus wishes to bring to the attention of the Court are especially within the ambit of its expertise.

Amicus suggests to the Court that because of its long-term experience with the surety industry and the bond form at issue here, that it is in an excellent position to inform the Court of interests other than those presented by the parties to this litigation and to aid the Court as it focuses its attention on the broader implications of possible rulings it might render in these proceedings.

Amicus respectfully suggests to this Court, in the strongest terms possible, that the position and perspective suggested by Amicus, if adopted by this Court, will be dispositive of this litigation.

Respectfully submitted,

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Date: January 13, 1993

QUESTIONS PRESENTED

1. Does 11 U.S.C. § 541(c)(1)(B) nullify the termination provision of a financial institution bond even though the termination of that bond cannot prevent any property interest of the debtor from passing to the bankruptcy trustee or estate?

2. Does the specific language of 12 U.S.C. § 1821(e)(12)(A) (1989), which precludes a conservator or receiver from nullifying the termination provisions of a financial institution bond, take precedence over the general power to enforce debtor's contracts granted by 11 U.S.C. § 541(c)(1)(B) (1978)?

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 92-1046

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,

Petitioner,

v.

JOHN B. CAMP, TRUSTEE, SECURITIES INVESTOR PROTECTION CORPORATION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

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BRIEF *AMICUS CURIAE* OF THE SURETY ASSOCIATION OF AMERICA IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

INTEREST OF *AMICUS CURIAE* [1] THE SURETY ASSOCIATION OF AMERICA

Amicus Curiae, the Surety Association of America (Amicus), organized in 1908, is one of the oldest trade associations and insurance rating bureaus in the United States. It is curently licensed as an advisory or rating organization or is otherwise recognized by all 50 states, the District of Columbia and Puerto Rico. Amicus serves

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[1] Petitioner, National Union Fire Insurance Company of Pittsburgh, Pa., has consented to the filing of this amicus brief. Its letter of consent is on file with the Clerk of Court. Respondent, John B. Camp, Trustee, Securities Investor Protection Corporation, does not consent to the filing of this amicus brief.

that portion of the insurance industry that develops and markets surety and fidelity bonds by acting as a common agent for its 635 member companies. Through lawful contact with regulators, self-regulating organizations, the public, and the courts, Amicus works to promote a climate in which bonds serve a useful purpose and to assure that bonds are available to the public when requested.

In 1916 Amicus and the American Bankers Association drafted a fidelity bond known as the Bankers Blanket Bond, Standard Form No. 1. Since then Amicus has cooperatively developed a variety of similar financial institution fidelity bond forms, usually in collaboration with industry trade groups representing the purchasers of the contract [e.g., American Bankers Association, United States League of Savings Institutions and National Association af Securities Dealers, Inc. (NASD)] to meet the specific needs of Insureds: the Standard Form 24 for banks; the Standard Form 22 for savings and loan associations; and the Standard Form 14 for stockbrokers and securities dealers, among others.[2]

Amicus has a legitimate and urgent interest in this litigation. At issue here is a hybrid of the Standard Form 14 (Form 14), marketed by National Union Fire Insurance Company of Pittsburgh, Pa. (Petitioner)[3] as part of the NASD[4] sponsored Group Fidelity Bond Buy-

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[2] See Appendix A, page 1a, The Surety Association of America Cause of Loss Experience Statement for Combined Coverage Blanket Fidelity Bonds, which lists the financial institutions covered by these products, as well as the uniform coverages provided.

[3] See Appendix D, page 5a, for excerpts from Petitioner's bond relating to coverage, discovery, definition of property and termination.

[4] NASD requires its members to "maintain a fidelity blanket bond" (NASD Rules, ¶ 2182). Securities Investor Protection Corporation (SIPC) requires all brokers to be members of NASD (15 U.S.C. § 78iii). See Appendix F, page 11a, Excerpts from SIPC's Fourth Circuit Brief *In re Waddell Jenmar Securities, Inc.*, which

ing Program,[5] under the name Securities Dealer Blanket Bond.

The 11th Circuit decision nullifying Section 12(c) of Petitioner's bond providing for its immediate termination upon the taking over of the insured by a receiver or other liquidator in the name of 11 U.S.C. § 541 (c)(1)(B) is a case of the first impression, presenting an entirely novel question of law for decision by this Court which cannot be governed by any existing precedent.

A viable market with willing purchasers and providers of fidelity and surety bonds permitting liberty of contract is of vital concern to Amicus.[6] In the words of the court in *Fidelity & Deposit Company of Maryland v. Thomas R. Conner, et al.*, 973 F.2d 1236, 1243 n.16 (5th Cir. Tex. 1992), refusing to permit such termination provisions will "result in a market with few or no providers and little or no affordable coverage." [7]

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recognizes on pages 28 and 29 that there is a requirement that broker-dealers obtain fidelity bonds.

[5] See Appendix H, page 17a, for the December 17, 1982 NASD memorandum announcing this program to its members.

[6] The present market for Form 14 bonds is viable. For instance, in December of 1992, in an informal Amicus poll of the top eight Amicus members (by premium volume) who were providers of fidelity insurance in 1992, it was determined that these eight insurance companies/groups provide fidelity insurance to approximately 4,500 securities dealers. The total current aggregate limit of coverage of these securities dealer bonds is approximtaely $4.16 billion. If the 11th Circuit decision is allowed to stand, that in-force coverage will be exposed to a risk that was neither contracted nor premium-rated for.

[7] For an insight into the view of an Amicus member as to the impact of removing the subject termination language from the bond, see Appendix G, page 14a, January 19, 1990 Letter From Continental Insurance Company to Federal Deposit Insurance Corporation (WDIC) Responding to an FDIC Inquiry.

Amicus is in a unique position to enlighten the Court on these critical issues.

INTRODUCTION AND SUMMARY OF ARGUMENT

Petitioner's bond [8] was written on a discovery basis.[9] This means that loss may be sustained at any time, even before the effective date of the bond, provided that the loss is discovered during the bond period, resulting from, among other things, dishonest acts of its employees.[10]

Form 14 [11] was developed by Amicus in 1936 containing the exact termination provision examined by the 11th Circuit in this litigation. That termination provision is found in Section 12(c) of the bond [hereinafter Sec. 12(c)], and provides for the immediate termination of the bond upon the taking over of the insured by a receiver or other liquidator or by state or federal officials.[12] A similar, and in most cases identical, termination provision is found in all financial institution fidelity bonds,

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[8] See Appendix D, page 5a, for pertinent excerpts from Petitioner's bond (National Union Fire Insurance Company of Pittsburgh, PA.'s Securities Dealer Blanket Bond).

[9] *Commercial Property Risk Management and Insurance Volume II*, American Institute for Property and Liability Underwriters, 3rd Ed. (1988).

[10] *In re Government Securities Corp.*, 972 F.2d 328 at 328 (11th Cir. 1992).

[11] See Appendix E, page 8a, for pertinent excerpts from the Amicus Standard Form 14 bond relating to coverage, discovery, definition of property and termination.

[12] The Amicus membership as a whole considers that provision to be a critical component of all financial institution bonds, without which it would be logical that these companies might adopt a more conservative underwriting posture to protect their individual economic interests. See Appendix G, page 14a, January 19, 1990 Letter From Continental Insurance Company to FDIC Responding to FDIC Inquiry.

and has continuously been in the Form 14 bond since 1936.[13]

Petitioner's bond was issued to protect GSC, a securities broker, from losses resulting from dishonest acts and provided in Sec. 12(c) that:

> The bond shall be deemed terminated or canceled as an entirety . . . immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials. . . .

Bond ¶ 12(c) (Exhibit "A" to Trustee's Amended Complaint served September 30, 1988).[14] When SIPC commenced a liquidation of the broker pursuant to the Securities Investor Protection Act of 1970 (SIPA), and made claim on Petitioner under the bond, Petitioner denied bond coverage on the ground that, pursuant to the provisions of Sec. 12(c), the bond terminated upon the appointment of the Trustee to oversee the insured's liquidation. The 11th Circuit affirmed the Bankruptcy Court and the Federal District Court holdings that Bankruptcy Code Section 541(c)(1)(B), which provides that an interest of the debtor in property becomes the property of the estate notwithstanding any provision in an agreement that, among other things is conditioned on taking possession by a custodian before bankruptcy proceedings are commenced, and that "effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property," [15] was "imported" into SIPA and therefore invalidated Petitioner's bond termination clause.

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[13] See Appendix C, page 3a, for excerpts from Fidelity and Deposit Company of Maryland's 1936 Standard Form 14 Revised relating to coverage, discovery, definition of property and termination.

[14] See Appendix D, page 5a, for the complete text of 12(c) of Petitioner's bond.

[15] See Appendix B, page 2a, for the full pertinent text of 11 U.S.C. § 541(c)(1)(B).

The 11th Circuit's holding immediately brings into play:

(1) The specific interest in property (the GSC bond) which 11 U.S.C. § 541(c)(1)(B) targeted and intended to protect:

(2) The fact that GSC's only "interest in property" in the bond was in the pre-paid premium, and in any claims that were discovered and made by GSC prior to May 12, 1987, when SIPC applied to the court for an order placing GSC into SIPA liquidation procedures which immediately terminated the bond, both of which interests in property did not terminate upon termination of the bond;

(3) The fact that Sec. 12(c)'s termination provision is immune from 11 U.S.C. § 541(c)(1)(B);

(4) The true purpose and meaning of 11 U.S.C. § 541(c)(1)(B) of the Bankruptcy Act of 1978 and its relationship to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) public policy declaration in 12 U.S.C. § 1821(e)(12)(A)[16] that a conservator or receiver may enforce any contract, other than a Director's and Officer's (D & O) liability insurance contract or a depository institution bond;

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[16] See Appendix B, page 2a, for the pertinent text of 12 U.S.C. § 1821(e)(12)(A).

ARGUMENT

POINT I

11 USC § 541(c)(1)(B) HAS NO BEARING ON OR APPLICATION TO THE FIDELITY BOND'S SECTION 12(c) AUTOMATIC TERMINATION PROVISION

A. Termination Of The Bond Did Not And Could Not Prevent Transfer Of Debtor's Interest In Property To The Trustee; Hence, Bond Sec. 12(c) Is Immune To Nullification By 11 U.S.C. § 541(c)(1)(B).

Whether or not § 541 of the Bankruptcy Act is deemed to have been incorporated into the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. § 78aaa, et seq.,[17] it is not applicable to the case at bar.

The language of § 541(c)(1)(B) pertinent to this case is:

> . . . an *interest of the debtor in property* becomes property of the estate . . . notwithstanding any provision in an agreement . . . that is conditioned . . . on the appointment of . . . a trustee . . . , and that effects . . . a . . . *termination of the debtor's interest in property.* (Emphasis added).

The Historical and Revision Notes accompanying 11 U.S.C. § 541, and pertinent to § 541(c)(1)(B) read:

> Subsection (c) invalidates restriction on the transfer of *property of the debtor*, in order that all of the *interests of the debtor in property* will become property of the estate. The provisions invalidated are those that restrict or condition transfer of *the debtor's interest*, and those that are conditioned on the insolvency or financial condition of the debtor, on the com-

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[17] As this question was the focus of the litigation below, Amicus only treats of the new material discussed here. However, Amicus *does* support Petitioner's position.

mencement of a bankruptcy case, or on the appointment of a custodian of the debtor's property.[18]

It is a given that a fully paid insurance policy is a valid and binding contract between Petitioner and GSC, and therefore constitutes *property* of the bankruptcy estate.[19] Amicus points out that it is also a given that the only 11 U.S.C. § 541(c)(1)(B) interest of the debtor in *that* property consists of:

(1) The right to the pro rata return of the pre-paid premiums on termination for *any* reason[20] and is, by definition, payable *only* after termination, so that the interest in that property is clearly *not* terminated when the bond is terminated; and

(2) The right to the proceeds of any monies payable to GSC for cognizable claims discovered and made against the policy prior to the policy's termination also survives termination, and is payable to the trustee as soon as settlement is made after termination.

An example of the courts' typical expression on § 541(c)(1)(B) is: "Clauses which purport to terminate, limit or otherwise modify *a debtor's interest in its property* are unenforceable under the Code." *Matter of Railway Reorganization Estate, Inc.*, 133 B.R. 578, 582 (Bkrtcy. D. Del. 1991). (Emphasis added).

In the above analyses, and in the language of the statute itself, the focus is on *the debtor's interest in property.* The point is that the purpose of the statute is to prevent third parties from using contracts controlling such prop-

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[18] Notes of Committee on the Judiciary, S. Rep. 95-989, 95th Cong., 2d Sess. (1978), U.S. Code Cong. and Admin. News 1978, p. 5869. (emphasis added).

[19] *In re Cahokia Downs*, 5 B.R. 529, 531 (Bkrtcy. So.Dist.Ill. 1980).

[20] See Appendix D, page 7a, for the pertinent excerpt from National Union Fire Insurance Company of Pittsburgh, PA's Securities Dealer Blanket Bond.

erty to deny transfer of the debtor's interest in that property to the bankruptcy estate. An example of this principle is that a bankruptcy default clause in a financing agreement was found void so that the lender could not repossess a debtor's automobile and, therefore, prevent the debtor's interest in the car from becoming property of the estate where the payments and insurance were current. *In re Winters*, 69 B.R. 145 (Bkrtcy. D.Ore. 1986).

Similarly, in *In re Mitchell*, 85 B.R. 564 (Bkrtcy. D.Nev. 1988), the court examined a clause in a retail installment contract for the purchase of a car providing that, in the event of bankruptcy, the secured creditor could accelerate the unpaid balance and repossess the car. The court held that, under 11 U.S.C. § 541(c)(1)(B), such a clause could not prevent the debtor's interest in the car from becoming property of the debtor's estate. *Id.* at 566. Likewise, in *In re Jeanes Mechanical Contractors, Inc.*, 32 B.R. 657 (Bkrtcy. W.D.Ky. 1983), the court was faced with a forfeiture clause in a construction contract that gave a surety, as subrogee, the right to take possession of supplies in the subcontractor/debtor's possession in the event that the subcontractor/debtor filed for bankruptcy. The court held such forfeiture clause unenforceable under 11 U.S.C. § 541(c)(1)(B). *Id.* at 659.[21]

An obvious distinction between the above cited cases and the case at bar is that, in the cited cases, third parties were attempting to deprive the various debtors' estates of the respective debtors' interests in property (i.e., cars and materials) whereas, in the present case, the termination of the bond does not effect or attempt to effect a deprivation of property from the debtor's estate.

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[21] For additional examples of this principle, see *Matter of Lawson*, 67 B.R. 94 (Bkrtcy. M.D. Fla. 1986); *Matter of Railway Reorganization Estate, Inc., supra*; *In re Mumpfield*, 140 B.R. 578 (Bkrtcy. M.D. Ala. 1991).

As demonstrated, the interest of the debtor in this case is 1) the return of the unearned premium and 2) the right to payment for cognizable claims discovered prior to the policy's termination, that is, the property is separate and distinct from the interest in the property. These interests are not affected by the termination of the bond but survive that event, thus clearly and categorically becoming an unfettered and full part of the debtor's estate.

An additional distinction between the contract at issue here and those at which § 541(c)(1)(B) is directly aimed is that there is no third party to the GSC bond. The debtor itself is the owner of the bond. Hence, termination of the bond cannot transfer any of the debtor's interests in property to anyone other than the Trustee.

Accordingly, no interest of GSC in property is terminated upon bond termination, and 11 U.S.C. § 541(c)(1)(B) has no application to the facts of this case, thereby rendering 12(c) immune to nullification based on that statute.

Consequently, a liquidating trustee concerned only with collecting the debtor's interests in property loses no interest in property on the termination of a debtor's Form 14 financial institution fidelity bond.

In the alternative, if the Trustee/Appellee maintains that the interest transferred pursuant to § 541(c)(1)(B) was solely GSC's interest in the fidelity bond itself, which has been shown not to be the case, then that claim must also fail.

In order for the Trustee to collect an asset, the failed institution must have it as an asset. Here, GSC did not own as an asset a fidelity bond without a Sec. 12(c) immediate termination clause. Hence, the only asset transferrable is GSC's interest in a terminated bond. *See Conner*, 973 F.2d 1236, 1243, discussed, *infra*.

B. As a Congress-Created Insurer,[22] Neither SIPC Nor Its Appointed Liquidator Can Override the Termination Provisions Of A Financial Institution's Fidelity Bond.

Over the years, Congress has created insurers to protect the public against the failure of financial institutions. It created the Federal Savings and Loan Insurance Corporation (FSLIC)[23] to protect savings and loan association's customers; the Federal Deposit Insurance Corporation (FDIC)[24] to protect bank customers; and the SIPC[25] to protect the customers of stockbrokers and securities dealers. All three corporations were given substantially similar powers and goals.

All three categories of insured financial institutions are required to protect themselves against employee dishonesty through commercially underwritten fidelity bonds, substantially similar to the bond at issue here.

Considering that homogenous background, it is imminently reasonable to assume that when Congress approved the immediate termination language in the FDIC context, it also approved the identical language in the SIPC context.

The principal issue in *Conner* was whether, after taking over a failed bank, the FDIC could override a regulatory

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[22] SIPC is an insurer with limited coverage. It cannot guarantee that customers will recover their investments; investment securities deposited with brokers constantly fluctuate in value. Nevertheless, SIPC was intended to provide protection for brokerage house customers who left cash or securities on deposit, similar to the protection afforded bank depositors by the FDIC. *Securities & Exchange Commission v. Albert & Maguire Securities Co., Inc.*, 560 F.2d 569 (3rd Cir. 1977). See also *Massachusetts Financial Services, Inc. v. SIPC*, 411 F. Supp. 411 (D.C. Mass. 1976), aff'd 545 F.2d 754 (1st Cir. 1976), *cert. den.*, 431 U.S. 904, 97 S. Ct. 1696, 52 L.Ed.2d 388 (1977).

[23] 12 U.S.C. § 1724 (1934).

[24] 12 U.S.C. § 1811 (1950).

[25] 15 U.S.C. § 78ccc (1970).

exclusion in the bank's D & O Liability Insurance Policy thereby making the insurer liable for the FDIC's claims against the D & O policy.

In rejecting the FDIC's claims and affirming the District Court's grant of summary judgment in favor of the insurer, the court noted: "[T]he FDIC overlooks the very important fact that in order to marshall and collect an asset, the failed bank must have it as an asset. Here, the bank did not own as an asset directors' and officers' liability insurance without an FDIC endorsement. Therefore, such argument fails." 973 F.2d at 1243.

Addressing the legislative history of 12 U.S.C. § 1821 (e) (12) (A), the court observed that:

> Congress rejected the FDIC's proposed language and opted for the following:
>
> > "The conservator or receiver may enforce any contract, *other than a director's or officer's liability insurance contract or a depository institution bond*, entered into by the depository institution notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of, solvency or the appointment of a conservator or receiver."

Conner, 973 F.2d at 1242 (Court's emphasis); 12 U.S.C. § 1821(e) (12) (A) (1989).

Amicus further suggests that in using the broad language quoted above in § 1821(e) (12) (A), Congress announced an overwhelming and controlling public policy favoring the immediate termination clause. This same policy should apply to all Congress-created insurers, including SIPC.

C. The FDIC, Secretary of the Treasury and Attorney General Recognize That 12 U.S.C. § 1821(e)(12)(A) Prevents a Receiver or Conservator From Nullifying the Immediate Termination Provision of a Financial Institution Bond.

§ 220(b)(3) of FIRREA, enacted August 9, 1989, required the FDIC, the Secretary of the Treasury, and the Attorney General to conduct a comprehensive study of D&O insurance and depository institution bonds. A Report of that study was completed September 13, 1991.[26]

The Report recognized that, under current statutory and case law, the immediate termination provisions of financial institution bonds will be enforced.[27] This Report, as it applies to financial institution bonds, essentially repeats the same arguments that the FDIC made to Congress when it was considering FIRREA. Those arguments were rejected by Congress and by *Conner*. See Point I(B), *supra*.

This Report fully supports Amicus' view that, under current law, the 11th Circuit's holding totally ignores both the true nature of the interest in property at stake in this litigation, and the fact that the failure of 11 U.S.C. § 541(c)(1)(B) to address the 12(c) concept at all, and FIRREA's § 1821(e)(12)(A) providing that a conservator or receiver may enforce any contract other than a D & O liability insurance contract or a depository institution bond, sets down the overwhelming public policy favoring the immediate termination clause. Paraphrasing *Conner*, 973 F.2d 1242, Amicus urges that the 11th Circuit's effort to create insurance coverage where there

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[26] See Appendix I, page 22a, Excerpt from FDIC Report, Section I(A)-(C), pp. 1-3.

[27] The FDIC cites as its authority for this statement the case of *FDIC v. Aetna Casualty & Surety Co.*, 903 F.2d 1073 (6th Cir. 1990), which held that termination provisions almost identical to Sections 12 and 13 of the Blanket Bond in this case were enforceable and not against public policy.

is none should be rejected and SIPC should be referred to Congress: the only proper way to change the law is by specific Congressional action, and not by judicial decree.

D. The Accepted Principles of Statutory Construction Support a Reversal of the Lower Court's Holdings.

In construing a statute in a case of first impression, the court must first look to the plain language of the statute itself. Only if the statute is ambiguous should the court consider the legislative history. *Cabalceta v. Standard Fruit Co.*, 883 F.2d 1553, 1559 (11th Cir. 1989). See also: *U.S. v. Dadaian*, 818 F.2d 1443, 1448 (9th Cir. 1987), *mod. on reh.* 856 F.2d 1391; *Alacare Home Health Services, Inc. v. Sullivan*, 891 F.2d 850, 856 (11th Cir. 1990).

As pointed out in Section A, *supra* at page 8, 11 U.S.C. § 541(c)(1)(B) states in plain, unambiguous language that it applies only to a contract provision "that effects . . . a . . . termination of the debtor's interest in property." Since the immediate termination of GSC's fidelity bond did not terminate any GSC interest in property, the statute does not apply in this case.

The 11th Circuit's holding nullifying the immediate termination clause directly conflicts with congressional policy upholding the immediate termination clause, as evidenced by 12 U.S.C. § 1821.

The construction rule in such conflict cases is: To the extent that statutes can be harmonized, they should be, and in case of an irreconcilable inconsistency, the later and more specific statute usually controls the earlier and more general. *Hellon & Associates v. Phoenix Resort Corp.*, 958 F.2d 295, 297 (9th Cir. 1992).

Following that rule, 12 U.S.C. § 1821(e)(12)(A), passed in 1989, should prevail over 11 U.S.C. § 541(c)(1)(B), passed in 1978 and most recently amended in 1984.

POINT II

MAKING FINANCIAL INSTITUTIONS' D & O POLICIES AND FIDELITY BONDS ALSO COVER THE FINANCIAL FAILURE OF THEIR INSUREDS BY NULLIFYING SELECTED PROVISIONS OF SUCH CONTRACTS CAN ONLY MAGNIFY THE ADVERSE ECONOMIC EFFECTS OF THOSE FAILURES.

If coverage for failure of financial institutions, in the large amounts required by the risk, had been obtainable from commercial insurers at an affordable price, then Congress would not have had to create the FSLIC, FDIC, and SIPC.

Therefore, if the current efforts to indirectly transform D & O policies and fidelity bonds into co-insurance or excess insurance for the Congress-created insurers are successful, then the availability of those D & O policies and financial institution bonds will be diminished to a large extent, if indeed they do not vanish from the marketplace altogether.[28]

The court in *Conner* reported on the concern of Congress in that regard as pertains to D & O policies as follows:

> Concerned that refusing to permit regulatory and insured v. insured exclusions might eliminate the market for D & O coverage for financial institutions, Congress commissioned a comprehensive study which consisted of written submissions from numerous insurers, banking and insurance industry representatives, and others. See Brief of Appellee and Cross-Appellee Fidelity and Deposit Co. of Md. at 36-37,

[28] The Amicus membership as a whole considers that provision to be a critical component of all financial institution bonds, without which it would be logical that these companies might adopt a more conservative underwriting posture to protect their individual economic interests. See Appendix G, page 14a, January 19, 1990 Letter From Continental Insurance Company to FDIC Responding to FDIC Inquiry.

> *FDIC v. Conner*, No. 91-2782 (5th Cir. filed Dec. 18, 1991) ["F & D Brief"]. These submissions—see, e.g., Plaintiff's Exhibits 5 & 6—indicate concern that refusing to permit regulatory and insured v. insured exclusions would result in a market with few or no providers and little or no affordable coverage.

973 F.2d at 1242, fn. 16.[20]

The fidelity bond market was also surveyed at the same time that the D & O study was made and the response was substantially similar to that reported to Congress for the D & O policy market, to the effect that long-term loss of coverage would result. Clearly, such an outcome would far outweigh any short-term funds the government might receive from litigation, as in the case at bar.

Conner cautions against a judicial rewriting of insurance policies, even where the public interest might seem to be served, and quotes the Supreme Court as follows:

> "The general rule is that competent persons shall have the utmost liberty of contract and that their agreements voluntarily and fairly made shall be held valid and enforced in the courts." *Twin City Pipe Line v. Harding Glass*, 283 U.S. 353, 356, 51 S.Ct. 476, 477, 75 L.Ed. 1112 (1931).

973 F.2d at 1241.

And, although contracts may be voided on grounds of public policy: "Public policy is to be ascertained by reference to the laws and legal precedents and not from general consideration of supposed public interests." *Id.* at 1241, quoting *Muschany v. United States*, 324 U.S. 49, 66, 65 S.Ct. 442, 451, 89 L.Ed. 744 (1945).

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[20] Although the *Conner* court was only concerned with D & O policies, the report also addresses similar concerns as to financial institution bonds.

CONCLUSION

This litigation is the quintessential example of the federal regulator's continuing and dogged attempt to make inappropriate use of insurance contracts, to the point of causing their breach, as a way to produce funds to hold the government harmless from the dual crises in the banking and securities industries which the insurance industry did nothing to create and to which its policies and bonds are not answerable, precisely because those contracts expressly provide for regulatory exclusions and/or provisions terminating coverage upon the occurrence of a government takeover. These efforts, if successful, will ultimately be self defeating in that they will eliminate the very coverages which the government seeks to exploit. Accordingly, SIPC's effort to create insurance coverage where there clearly is none should be rejected. Also involved here are important concepts of breach of contract and unconstitutional takings by the government which it should not be necessary for this Court to reach because of the dispositive nature of the arguments set forth by Amicus herein.

The Petition for Writ of Certiorari should be granted and in due course the judgment of the 11th Circuit Court of Appeals should be reversed.

Respectfully submitted,

Of Counsel:
ROBIN V. WELDY
THE SURETY ASSOCIATION OF AMERICA
100 Wood Avenue South
Iselin, New Jersey 08830

Date: January 13, 1993

HARVEY C. KOCH
Counsel of Record
KOCH & ROUSE
Suite 2657
601 Poydras Street
New Orleans, Louisiana 70130
(504) 566-7528
Counsel for Amicus Curiae

APPENDICES

APPENDIX A

THE SURETY ASSOCIATION OF AMERICA

CAUSE OF LOSS EXPERIENCE STATEMENT
FOR COMBINED COVERAGE BLANKET FIDELITY BONDS
(Stated as percentages of Direct Losses Incurred)

ALL COMPANIES—COUNTRYWIDE—CALENDAR YEAR 1990

	Comm'l Banks	Savings Banks	S & L Assns	Inv. Bankers Stockbrokers Finance Cos.	All Other Financial Institutions	Forms 25 25L and 26
Fidelity Insuring Agreement—						
Dishonesty of Regular Employees	82.4%	66.5%	66.7%	92.6%	46.4%	96.5%
EDP Organizations (cov'd as empl's)	0.0	0.0	0.3	0.2	0.0	0.0
All other cov'd under Fid Ins Agrmt	1.9	8.2	3.4	0.4	17.6	0.4
On Premises Insuring Agreement—						
Misplacement	0.2	0.0	1.8	1.0	0.0	0.0
Burglary	1.0	0.8	0.4	0.9	1.1	0.0
Robbery/Hold-up	0.9	20.1	16.9	0.4	4.2	0.0
All other cov'd under On Prem Ins Agrmt	2.2	1.2	8.1	0.7	11.6	0.0
Intransit Insuring Agreement—						
Misplacement	0.1	0.0	0.0	0.1	0.0	0.0
Robbery/Hold-up	0.0	0.0	0.0	0.6	0.7	0.0
All other cov'd under In Trans Ins Agrmt	0.8	0.1	0.1	0.0	0.0	0.0
Forgery (Not By Empl) Ins Agrmts—						
All cov'd under Forg Ins Agrmts D & E	9.5	1.9	2.1	1.9	8.6	1.5
All Other—						
All other not otherwise classified	1.0	1.2	0.2	1.2	9.8	1.6
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

APPENDIX B

STATUTORY PROVISIONS INVOLVED

11 U.S.C. § 541(c)(1)(B) 1978

§ 541. Property of the estate.

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—

* * * *

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

12 U.S.C. § 1821(e)(12)(A) 1989

(12) Authority to enforce contracts

(A) In general

The conservator or receiver may enforce any contract, other than a director's or officer's liability insurance contract or a depository institution bond, entered into by the depository institution notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of, insolvency or the appointment of a conservator or receiver.

APPENDIX C

EXCERPT FROM FIDELITY AN DEPOSIT COMPANY OF MARYLAND BROKER'S BLANKET BOND

Standard Form 14 Revised
(Adopted July 2, 1936)
(Not a Part of the Record)

In consideration of an annual premium, the FIDELITY AND DEPOSIT COMPANY OF MARYLAND, hereinafter referred to as Underwriter, hereby undertakes and agrees to indemnify _____ _____, hereinafter referred to as the Insured and hold it harmless, to an amount not exceeding _____Dollars ($_____), from and against any losses sustained by the Insured subsequent to noon of the date hereof and while this bond is in force and discovered by the Insured subsequent to noon of the date hereof, and prior to the expiration of twelve months after the termination or cancelation of this bend as an entirety as provided in the first paragraph of Condition 11 or in any other manner.

* * * *

4. The Insured shall give to the Underwriter written notice of any loss hereunder as soon as possible after the Insured shall learn of such loss, and within ninety days after learning of such loss shall file with the Underwriter an itemized proof of claim duly sworn to. The Underwriter shall have thirty (30) days after notice and proof of loss within which to investigate the claim, but where the loss is clear and undisputed, settlement shall be made within forty-eight hours; and this shall apply notwithstanding the loss is made up wholly or in part of securities of which duplicates may be obtained.

* * * *

11. This bond shall be deemed terminated or canceled as an entirety—*(a)* thirty days after the receipt by the Insured of a written notice from the Underwriter of its desire to terminate or cancel this bond, or *(b)* immediately upon the receipt by the Underwriter of a written request from the Insured to terminate or cancel this bond, or *(c)* immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or *(d)* immediately upon the taking over of the Insured by another institution. The Underwriter shall, on request, refund to the Insured the unearned premium computed pro rata if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Underwriter, or if terminated or canceled as provided in subdivision *(c)* or *(d)* of this paragraph. The Underwriter shall refund to the Insured the unearned premium computed at short rates if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Insured.

This bond shall be deemed terminated or canceled as to any Employee—*(a)* as soon as the Insured shall learn of any dishonest or fraudulent act on the part of such Employee, without prejudice to the loss of any Property then in transit in the custody of such Employee, or *(b)* fifteen days after the receipt by the Insured of a written notice from the Underwriter of its desire to terminate or cancel this bond as to such Employee.

APPENDIX D

EXCERPTS FROM
NATIONAL UNION FIRE INSURANCE
COMPANY OF PITTSBURGH, PA.'S
SECURITIES DEALER BLANKET BOND
(Issue Date: January 29, 1987)
(Which Forms a Part of the Court Record)

I. *PREAMBLE TO INSURING AGREEMENTS*:

"SECURITIES DEALER BLANKET BOND

"The Underwriter, in consideration of an agreed premium, and subject to the Declarations made a part hereof, the General Agreements, Conditions and Limitations and other terms of this bond, agrees with the Insured, in accordance with the Insuring Agreements hereof to which an amount of insurance is applicable as set forth in Item 4 of the Declarations and with respect to loss sustained by the Insured at any time but discovered during the Bond Period, to indemnify and hold harmless the Insured for:"

* * * *

II. *BOND DEFINITION OF "PROPERTY"*:

DEFINITIONS

"Section 1. The following terms, as used in this bond, shall have the respective meanings stated in this Section:

"(b) 'Property' means money (i.e., currency, coin, bank notes, Federal Reserve notes), postage and revenue stamps, U.S. Savings Stamps, bullion, precious metals of all kinds and in any form and articles made therefrom, jewelry, watches, necklaces, bracelets, gems, precious and semi-precious stones, bonds, securities, evidences of debts, debentures, scrip, certificates, interim receipts, warrants, rights, puts, calls, straddles, spreads, trans-

fers, coupons, drafts, bills of exchange, acceptances, notes, checks, withdrawal orders, money orders, warehouse receipts, bills of lading, conditional sales contracts, abstracts of title, insurance policies, deeds, mortgages under real estate and/or chattels and upon interests therein, and assignments of such policies, mortgages and instruments, and other valuable papers, including books of account and other records used by the Insured in the conduct of its business, and all other instruments similar to or in the nature of the foregoing including Electronic Representations of such instruments enumerated above (but excluding all data processing records) in which the Insured has an interest or in which the Insured acquired or should have acquired an interest by reason of a predecessor's declared financial condition at the time of the Insured's consolidation or merger with, or purchase of the principal assets of, such predecessor or which are held by the Insured for any purpose or in any capacity and whether so held by the Insured for any purpose or in any capacity and whether so held gratuitously or not and whether or not the Insured is liable therefor."

III. *DISCOVERY OF LOSS AND WHEN DISCOVERY OCCURS*:

"LOSS—NOTICE—PROOF—LEGAL PROCEEDINGS

"Section 4 . . . "At the earliest practicable moment after discovery of any loss hereunder the Insured shall give the Underwriter written notice thereof. . ."

"Discovery occurs when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred even though the exact amount or details of loss may not be then known. Notice to the Insured of an actual or potential claim by a third party which alleges that the Insured is liable under circumstances, which if

true, would create a loss under this bond constitutes such discovery."

IV *BOND TERMINATION LANGUAGE*:

"Section 12. This bond shall be deemed terminated or canceled as an entirety:

(a) sixty days after the receipt by the Insured of a written notice from the Underwriter of its desire to terminate or cancel this bond, or

(b) immediately upon the receipt by the Underwriter of a written request from the Insured to terminate or cancel this bond, or

(c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or

(d) immediately upon the taking over of the Insured by another business entity, or

(e) If the Insured is a Registered Management Investment Company covered as a sole Insured, this bond shall not be canceled, terminated or modified except after written notice shall have been given by the acting party to affected party, and to the Securities and Exchange Commission, Washington, D.C., not less than sixty days prior to the effective date of such cancellation, termination or modification.

The Underwriter shall, on request, refund to the Insured the unearned premium, computed pro rata, if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Underwriter, or if terminated or canceled as provided in sub-section (c) or (d) of this paragraph. The Underwriter shall refund to the Insured the unearned premium computed at short rates if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Insured.

* * * *

APPENDIX E

EXCERPTS FROM SURETY ASSOCIATION OF AMERICA'S FINANCIAL INSTITUTION BOND

Standard Form 14

(Revised to October, 1987)

(Not a Part of the Record)

The Underwriter, in consideration of an agreed premium, and in reliance upon all statements made and information furnished to the Underwriter by the Insured in applying for this bond, and subject to the Declarations, Insuring Agreements, General Agreements, Conditions and Limitations and other terms hereof, agrees to indemnify the Insured for:

* * * *

(o) Property means Money, Certificated Securities, Uncertificated Securities of any Federal Reserve Bank of the United States, Negotiable Instruments, Certificates of Deposit, documents of title, Acceptances, Evidences of Debt, security agreements, Withdrawal Orders, certificates of origin or title, Letters of Credit, insurance policies, abstracts of title, deeds and mortgages on real estate, revenue and other stamps, tokens, unsold state lottery tickets, books of account and other records whether recorded in writing or electronically, gems, jewelry, precious metals of all kinds and in any form, and tangible items of personal property which are not hereinbefore enumerated.

* * * *

DISCOVERY

Section 3. This bond applies to loss discovered by the Insured during the Bond Period. Discovery occurs when the Insured first becomes aware of facts which would cause a reasonable person to assume that

a loss of a type covered by this bond has been or will be incurred, regardless of when the act or acts causing or contributing to such loss occurred, even though the exact amount or details of loss may not then be known.

Discovery also occurs when the Insured receives notice of an actual or potential claim in which it is alleged that the Insured is liable to a third party under circumstances which, if true, would constitute a loss under this bond.

* * * *

TERMINATION OR CANCELATION

Section 12. This bond terminates as an entirety upon occurrence of any of the following:—(a) 60 days after the receipt by the Insured of a written notice from the Underwriter of its desire to cancel this bond, or (b) immediately upon the receipt by the Underwriter of a written notice from the Insured of its desire to cancel this bond, or (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another institution, or (e) immediately upon exhaustion of the Aggregate Limit of Liability, or (f) immediately upon expiration of the Bond Period as set forth in Item 2 of the Declarations.

This bond terminates as to any Employee or any partner, officer or employee of any Processor—(a) as soon as any Insured, or any director or officer not in collusion with such person, learns of any dishonest or fraudulent act committed by such person at any time, whether in the employment of the Insured or otherwise, whether or not of the type covered under Insuring Agreement (A), against the Insured or any other person or entity, without prejudice to the loss of any

Property then in transit in the custody of such person, or (b) 15 days after the receipt by the Insured of a written notice from the Underwriter of its desire to cancel this bond as to such person.

Termination of the bond as to any Insured terminates liability for any loss sustained by such Insured which is discovered after the effective date of such termination.

APPENDIX F

PAGES 28 AND 29 FROM BRIEF OF APPELLEE SECURITIES INVESTOR PROTECTION CORPORATION (DATED DECEMBER 10, 1992) IN THE MATTER STYLED *IN RE WADDELL JENMAR SECURITIES, INC. v. NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.* UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT
Docket No: 92-2158

(Not Part of the Record)

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* * * *

In the present case, "employee" is unambiguously defined in the bond. NUFIC drew the agreement and NUFIC defined the term. Even if the term were ambiguous, the ambiguity would have been resolved in favor of the insured.

NUFIC relies upon *General Finance Corp. v. Fidelity & Casualty Co. of N.Y.*, 311 F.Supp. 353 (D.S.D. 1970), for the proposition that "the owner of an interest in an insured corporation is not included in the term 'employees' covered by a fidelity bond." (Appellant's brief, p. 14). However, NUFIC fails to inform this court that the Eighth Circuit *reversed* the district court *on this very issue* and found liability on the fidelity bond for the fraud and theft of the president and majority shareholder of the insured corporation. *General Finance Corp. v. Fidelity Casualty Co., of N.Y.*, 439 F.2d 981 (8th Cir. 1971). Accordingly, NUFIC's reliance upon *General Finance* for the proposition that the owner of a controlling interest in the insured cannot be a covered employee under a fidelity bond is misplaced and simply wrong.

NUFIC's attempt to imply that the bond contains a sweeping exclusion of all persons who controlled the corporation should also fail on public policy grounds. Were

the court to adopt NUFIC's argument, *all* principals in any corporation would be potentially excluded from the coverage of fidelity bonds. NUFIC is one of the principal underwriters of this coverage in the fidelity bond market and profits from the sale of these policies. Many insureds in this market are small corporations or wholly owned businesses. Thus, these corporations and their customers would be virtually unprotected against theft by corporate principals. The bond coverage would be a nullity as to any corporate principal even though the bonding company did not specifically contract for such sweeping limitation.

Furthermore, the public policy underlying the requirement that broker-dealers such as WJS obtain fidelity bonds runs counter to NUFIC's argument. A broker-dealer such as WJS is required to register with the Securities and Exchange Commission (the "Commission") under section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act.").[11] Such a registered broker-dealer must comply with the Commission's net capital rule.[12] The National Association of Securities Dealers ("NASD") was the self-regulatory organization with jurisdiction over WJS. The NASD requires all broker-dealers to carry fidelity bonds tied to the net capital rule requirement. Simply put, the net capital rule prescribes a test that ensures that registered broker-dealers have adequate liquid assets to meet their obligations to their investors and creditors, and its primary purpose is to protect the customers and creditors of registered broker-dealers from monetary losses that can occur when such a broker-dealer fails.[13] Thus, the requirement that a broker-dealer obtain a fidelity bond is meant to protect a broker-dealer's customers.

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[11] 15 U.S.C. § 78o(b) (1988 & Supp. II 1990).

[12] Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1991).

[13] *See* Jamroz, "The Net Capital Rule", 47 The Business Lawyer 863 (1992); Net Capital Rule, Exchange Act Release No. 27,249, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,501 (Sept. 15, 1989).

This public policy argument is supported in the case of *Foster v. NUFIC*, 902 F.2d 1316 (8th Cir. 1990). In that case, investors brought an action against NUFIC seeking to recover under a broker-dealer's fidelity bond for losses caused by the fraudulent and dishonest acts of the firm's owner. The investors had sought, but were denied SIPC protection.[14] In affirming the district court's order in favor of the investors, the 8th Circuit held that "[t]he fidelity bond was one statutorily required and should be liberally interpreted to carry out the purposes of the statute, the protetcion of the investing public." *Id.* at 1320.

* * * *

[14] The investors were not deemed to be "customers" under SIPA entitled to SIPC protection because they had not deposited their funds with the failed broker-dealer for the purpose of purchasing securities, but rather had loaned their money to the broker-dealer's owner. Nonetheless, after a jury trial in Arkansas, it was found that the investor's losses were due to the fraudulent and dishonest acts of the owner.

APPENDIX G

JANUARY 19, 1990 LETTER FROM CONTINENTAL INSURANCE COMPANY TO FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) RESPONDING TO FDIC INQUIRY

(Not Part of the Record)

CONTINENTAL
INSURANCE

Continental Guaranty
& Credit Corporation
180 Maiden Lane
New York, NY 10038

January 19, 1990

Mr. M. Lauck Walton, Counsel
Federal Deposit Insurance Corporation
550 17th Street, N.W., Room 4018
Washington, D.C. 20429

Re: FIRRERA STUDY

Dear Mr. Walton:

It is evident that no single information source exists which would provide reliable data along the lines as requested by the FDIC. As such, it is impossible to accumulate any statistics within Continental (or within the industry according to the Surety Association of America) to document the element of risk in continuing coverage on a Financial Institution Bond after the bank is placed under regulatory control.

In our experience the risk of claims activity is materially increased in the event the bond term is extended to provide coverage, or a loss discovery period to regulatory authorities. If nothing else, loss adjustment expense becomes a very significant loss contributor as diligent regulators seek to protect the public's funds. While we don't

keep figures segregating these costs of losses paid to regulators, I can tell you that such claims were a substantial contributor to my company's unsatisfactory results from financial institutions bond underwriting in the early 1980's.

The bond is a contract between the financial institution and the insurance company. The institution responds to requests for underwriting data (warranting its accuracy), and an insurer structures the contract and pricing for the product. A fundamental issue is the contractual relationship between the parties; no independent third party has direct right of recovery under a standard bond. The exclusion of coverage for change of control, or ownership is well documented. The exclusion for regulatory control has existed for over sixty years in the bond form.

We provide bonds for banks ranging from the largest institutions in the country to the small community banks. While underwriting issues vary according to size of the institution, one underlying judgment is always present. We provide bonds for clients who are considered to be effectively managed businesses which are financially sound.

This judgment is influenced by Section 12 of the SAA Bond form which states that coverages are terminated "immediately upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials. . . . . ".

If this condition is removed, or modified to extend a discovery period to such individuals, it is certain that our company, and possibly others, will adopt a more conservative underwriting posture.

This may severely restrict the availability and affordability of bonding to the very class of institution who can least afford to expose their own surplus to perils covered by the bond. In these cases, uncovered claims could ac-

celerate financial deterioration and the need for public ballouts and regulatory involvement.

/s/ Michael J. Beernaert
MICHAEL J. BEERNAERT
Executive Vice President

WRT/pg

cc: Beverley Wadsworth
William Gibson
Martin Haber
Wesley Tucker
Betsy Headd
John Urbanik
Jay Edenfield
Lloyd Provost
Francis LeMunyon

APPENDIX H

DECEMBER 17, 1982 NASD MEMORANDUM TO ALL MEMBERS ANNOUNCING GROUP FIDELITY BOND BUYING PROGRAM
(Not a Part of the Record)

Notices to Members should be retained for future reference.

NASD

National Association of
Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20008
(202) 728-8000

December 17, 1982

MEMORANDUM

TO: All NASD Members

RE: *GROUP FIDELITY BOND BUYING PROGRAM*

It gives me a great deal of pleasure to announce that the NADS sponsored program to provide fidelity bonds for NASD members will commence immediately. It will be underwritten by the National Union Fire Insurance Company of Pittsburgh, Pennsylvania, a member of the American International Group of Insurance Companies and administered by Marsh & McLennan Inc.

The program will be of significant benefit to most NASD members who are required to carry fidelity bonds. It will provide competitive premium rates and easy access to fidelity bonding coverage up to $500,000.

Here are some of the highlights of the program:

1) Members whose minimum fidelity bonding requirement is $500,000 or less will be eligible to participate in the program.

2) Members who wish to purchase more than their minimum required coverage may do so within the program, up to $500,000.

3) In most cases bonds will be issued without underwriting on receipt of a simple application and a check for the first annual premium. In most situations members will be able to calculate their own premiums as indicated in the attached material.

4) The amount of coverage purchased will apply to all insuring agreements. These will be no reduction in coverage for Securities Forgery or Fraudulent Trading.

5) There will be two deductible levels as follows:

Amount of Coverage	*Deductible*
Up to $250,000	$ 5,000
$250,000 to $500,000	$10,000

6) Members who do not generally carry customer accounts (i.e. those subject to paragraph (a)(2) of the SEC's net capital rule 15c3-1) will receive a 10% discount from the basic premium.

Definition of Employee

In Notice to Members No. 82-40, dated June 17, 1982, the Board of Governors of the Association asked for member comments on a proposed amendment to the NASD fidelity bonding rule which would add a definition of employee to the rule. After careful consideration of the comment letters received, the Board unanimously approved the amendment at its meeting on July 16, 1982. The amendment was filed with the Securities and Exchange Commission pursuant to Rule 19b-4 under the Securities Exchange Act of 1934. Commission approval of the amendment was received on December 1, 1982.

Text of the Amendment to Article III, Section 32
NASD Rules of Fair Practice

The following is the full text of new paragraph (e) to Appendix C of Article II, Setcion 32 of the NASD Rules of Fair Practice:

Definitions

(e) For purposes of fidelity bonding the term "employee" or "employees" shall include any person or person associated with a member firm (as defined in Article I, Section 3(f) of the By-Laws(except:

1) Sole Proprietors

2) Sole Stockholders

3) Directors or Trustees of member firms who are not performing acts coming within the scope of the usual duties of an officer or employee.

Effect of the Amendment

The amendment will require members to include under their fidelity bonding coverage most persons associated with their firms who are engaged in the investment banking or securities business.

Co-owners (partners and partial stockholders), officers, employees and registered principals and representatives will be required to be covered under members' fidelity bonds.

Persons associated with member firms who are sole owners (sole proprietors and sole stockohlders) will not be classified as employees and will not be required to be included under their firm's coverage. Such will also be true of Directors and Trustees of member firms who do not engage in activities on behalf of their firms which fall within the scope of the usual duties of officers or employees.

The definition of employee in the policy to be used in the group program has been amended to comply with the new definition of employee. Members who are not eligible for or who do not choose to join the group program will be required to bring their current bonds into compliance with the new definition of employee.

Grace Period

To provide members with sufficient time to bring their bonds into compliance either by joining the group program or by having their current bonds amended, a grace period of 12 months from December 17, 1982 will be allowed to all NASD members.

Enhancements to the Group Program

As soon as the Group Fidelity Bond Program is underway other coverages desired by members will be evaluated by the Fidelity Bonding Committee and offered to members. The first such coverage will be the Surety Bonds required by many State Blue Sky Laws.

Participation

The policy and rates are currently being filed in all states. Most states have file-and-use regulations but there are some whose regulations require specific approval. *If there is no informational material enclosed with this letter the policy and rates are not yet approved in your state.* As soon as such approval is received you will receive the necessary information to enable you to join the program.

The key to the success of any group insurance program is maximum participation by those who are eligible to joint such a plan. I urge those of you who are eligible to participate to do so either immediately or as soon as it is to your economic advantage.

Questions about the operation of the program, e.g., rates, coverage, applications, claims, etc. should be di-

rected to March & McLennan Inc. Location and phone numbers are in the enclosed informational material.

Questions relating to the fidelity bonding and the new definition of employee should be directed to A. John Taylor, Vice President, Variable Contracts at (202) 728-8328.

Sincerely,
GORDON S. MACKLIN
President

APPENDIX I

EXCERPTS FROM FDIC REPORT: REPORT ON DIRECTORS' AND OFFICERS' LIABILITY INSURANCE AND DEPOSITORY INSTITUTION BONDS PURSUANT TO SECTION 220(b)(3) OF THE FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989, DATED SEPTEMBER 13, 1991

* * * *

I

EXECUTIVE SUMMARY [1]

A. The Statute

The Financial Institutions Reform. Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183, was enacted on August 9, 1989. In § 220(b)(3), the statute requires a Report on Directors' and Officers' Liability Insurance. Subsection (A) reads as follows:

> The Federal Deposit Insurance Corporation shall, together with the Secretary of the Treasury and the Attorney General, conduct a comprehensive study of directors' and officers' liability insurance and depository institution bonds, and the availability of such insurance for directors and officers of insured depository institutions. The Study shall include:
>
> (i) consideration of State Laws limiting liability for directors and officers;
>
> (ii) the effect of contractual provisions limiting insurance coverage when an institution is placed in receivership or conservatorship;

---

[1] Additional views of the Treasury Department are set forth in Appendix F.

(iii) provisions limiting coverage when a claim is made by the Federal Deposit Insurance Corporation; and,

(iv) provisions limiting claims made by one insured against another insured.

In addition, the study shall consider the need for such insurance or bonds and the effect any change in any of the above noted conditions or terms may have on the future availability of such insurance, and the ability of depository institutions to attract qualified officers and directors.

B. Scope and Emphasis of the Study

The mandated study is directed to two specific lines of coverage in the broader property/casualty market, and even as to those lines, is focused on policies purchased by depository institutions. The two lines to be studied are directors' and officers' liability insurance ("D&O") and depository institution bonds ("bonds"). D&O protects directors and officers against liability arising from wrongful conduct that falls short of fraud or dishonesty.[2] The D&O policy is usually in two parts. In part I of the policy, the corporation is protected only to the extent that it indemnifies the director or officer. Under part II, the director or officer is protected directly if indemnification is not made or is impermissible. Financial institution bonds (also called blanket bonds) primarly protect the corporation from losses stemming from dishonesty by officers or employees (or directors acting as officers or employees).

---

[2] Throughout this study, an attempt has been made to summarize in generic terms what parts of D&O and bond policies cover, mean, or are argued to mean by carriers, insured officials, or the FDIC. In lieu of repeating "purportedly" or "in the view of . . ." as a preface to virtually every descriptive statement, all such statements must be read as providing a general overview (not addressing specific policy language) and as efforts to summarize interested parties' views, but not as an acknowledgement that such views are correct.

The principal emphasis of the study is on D&O insurance, as the specific inquiries in the statute relate almost entirely to that line, rather than to bonds. For example, the first of those specific statutory inquiries relates to state laws limiting liability of directors and officers even though they are guilty of gross negligence, or even recklessness. *See* § 220(b)(3)(A)(i). Such provisions have no effect on the fraud coverage of bonds. Similarly, though one bond underwriter formerly attempted to limit bond coverage when a claim was made by a regulatory agency, the vast majority of bonds do not contain such a provision and no such provision is proposed by the Surety Association of America (SAA) which formulates standard bond clauses for the industry. *See* § 220(b)(3)(A)(iii). Nor is there any bond provision which seeks to limit claims by one insured against another—indeed, in a bond there is but one insured, the corporation itself. *See* § 220(b)(3)(A)(iv).

With respect to § 220(b)(3)(A)(ii), bond provisions which terminate the bond upon change of control or failure, and which eliminate a traditional provision that permits purchase of an extended period of insurance during which losses could be ascertained (extended "discovery" clauses), may have some impact on the FDIC's position in a limited number of cases, and on bond affordability. With respect to the more general inquiries posed by Congress, provisions in bonds which limit coverage, as for instance by excluding certain types of fraud, are relevant to the study only because they may affect affordability of bonds. The reduction of coverage affects their usefulness to depository institutions and may raise questions as to whether it is prudent to purchase coverage with major gaps. There is no evidence in the literature or elsewhere, however, that the availability of bonds has any effect whatsoever on the willingness of officers or directors to serve. Nevertheless, we have included an analysis of bond provisions in the report.

In sum, the study responds to Congress' specific inquiries as to D&O insurance, responds generally as to "availability," "affordability" and "need" for both D&O and bonds, and as to the effect that availability of D&O insurance has on the willingness of directors to serve.

C. Interest of the Study Agencies

The agencies designated by Congress to study this issue —(the Federal Deposit Insurance Corporation ("FDIC"), the Secretary of the Treasury, and the Attorney General) —have each either directly or indirectly taken public positions in litigation or elsewhere which bear on some or all of the issues presented.

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